

THE BOOMERS' DILEMMA

Even though the market delivered a substantial recovery in the fourth quarter of 2001, it was down for the second year in a row. For the years 2000 and 2001, the S&P 500 returned -9.2% and -11.9%, respectively, for a two-year compounded return of -20%. While CornerCap's returns have been up nicely over this time, most investors have suffered, and some have lost over half of their stock market investments. These recent tragedies are important, but we must always be moving on to something more important—the future.

What is going to happen to the investment markets over the next few years? As our long-time clients know, we are not much on forecasting. But, as they also know, our commentaries frequently state our strong opinions about the valuations of the market, behavior of investors, and the economic implications, which are forecasts in effect. We have been pretty good with the bubbles, having accurately called both the oil bubble of 1980 and the technology bubble of 2000, and of much greater importance, we have made investment decisions to capitalize on those market extremes. But the bubble has burst (or is still bursting), so what comes next?

THE SAVINGS PROBLEM

From their very beginnings, the influence of the baby boomers on our economy has been dramatic. There are 76 million people in the boomer generation, people from 37 to 55 years of age. Over the last 30+ years, we have followed them through diapers, trend-setting stores, illegal drugs, sporty autos, child care for working moms, improved housing, fast foods at home and away from home, etc. Over the next 30+ years, we will follow them through the discount stores, legal drugs, basic transportation, and retirement food and housing. These are very long-term, gradually moving trends, but we, as investors must be aware of the changing spending patterns that result.

The bottom line is that they do not have enough money to retire. . . . We will simply have fewer early retirees and more Wal-Mart greeters.

As important as the spending patterns are for these boomers, the savings trends are equally important. The boomers have not been savers. Their savings rate is essentially nonexistent. Consumer debt has risen to an all-time high. The continued availability of credit, even when we were in the middle of a recession, combined with the Fed-induced lure of lower interest rates, has resulted in a mountain of consumer debt. With consumers' income being diverted to repay this debt, in addition to their continued need to buy goods and services, how much will be left over for increased savings?

As the market price/earnings multiples went from below ten in the early '80s to the mid-thirties in the late '90s, many boomers assumed that they could avoid saving because they would be "saved" by the market, which was not a good assumption. The boomers are continuing to hold onto that hope. That hope is fed by occasional market pops like we saw last quarter. The market will not save them. The bottom line is that they do not have enough money to retire.

How will the boomers solve this enormous problem? To some degree, they will find a way to increase their savings' rate over the coming decades. But, to a much greater degree, they will deal with their lifestyle in their senior years the same way they dealt with their lifestyle in their earlier years, by working more. In their earlier years, the progression of the working mom produced the added resources needed to provide an acceptable lifestyle. In their senior years, the working retiree will provide the additional resources needed. We will simply have fewer early retirees and more Wal-Mart greeters.

THE INVESTMENT PROBLEM

No one wants to burst anyone's bubble. In fact, it is not good business, especially when you are an investment adviser. Just read or watch the many market prognosticators who promote fantasy to the buying public on a daily basis. No one wanted to

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THE BOOMERS' DILEMMA (CONTINUED)

hear about a bubble two years ago, and they do not want to hear about one now. But, one cannot be successful as an investor if he denies reality in favor of fantasy. The reality is that there is a bubble still present in the market, differently clad than the tech bubble, but it has the same potential for creating problems for investors in the coming years.

The characterization of this bubble is based on a few investment principles that are time tested and cannot be disputed, at least not in our minds. First, stock market returns are a function of just two things: stock appreciation (future growth) and dividends paid (current yield). Over the long term, both of these return items will be derived from corporate earnings. Of course, over shorter periods of time, market mania can make anything happen to stock prices. Since we have no clue what the masses might decide to do in the near term, we will just address what we know, which is that the long-term market will be determined by what happens to corporate profits.

We have good news. Long-term corporate profits are not that difficult to forecast. Studies have shown that corporate earnings grow at something close to the rate of GDP growth. The best economic environment for GDP (and earnings) growth is low inflation, and in that environment, the best we can expect is a growth in the range of 6% to 6.5%. To use this rate as our earnings forecast would be optimistic for a couple of reasons. First, there is no guarantee that our economy will be able to sustain the current low inflation, optimal environment. Secondly, earnings growth has actually slightly lagged GDP growth over the years. According to a study by Rob Arnott of First Quadrant, this lag effect relates to the portion of GDP growth that comes from new business enterprises that are not available to the public market.

The other element in our stock market return is dividends. Dividend yields for the market have declined from over 6% in 1982 to around 1.4% now. Add this dividend yield to our growth forecast presented above, and we have a long-term forecast for stock market returns of 7.5% to 8%. Is this around what you expect? What are the media prevalent market analysts saying? Over the last two years, would not you say that most of them have significantly lowered their forecasts from 15% to 18% down to a more "conservative" 10% to 13%? The difference between our forecast and their hope-based forecast is huge, and it has dramatic implications, especially for our baby boomers. Maybe we are still missing something.

Oh yes, we are missing something. What you have to pay for something is always important, which is a lesson only

recently learned by many investors. What are we currently paying for the earnings of "the market," and is it too high, too low, or just about right? The market (S&P 500) is currently priced in the range of 30 to 35 times earnings. This is at the high end of any historical levels. However, many analysts tell us that this multiple may be reasonable considering the current and projected modest levels of inflation (1% to 2%) and the low yields on bonds, the primary alternative investment that competes with stocks. Inflation and bond yields tend to be inversely correlated to price/earnings multiples, so higher than average multiples are certainly justified at this time. While we may be able to justify (or rationalize) the current multiples for the market, there is no justification for a further multiple expansion from this point. Investors' returns will come solely from earnings growth and dividends.

DEALING WITH THE DILEMMA

The starting point for dealing with the boomers' dilemma is to take a realistic view of the future. Expectations for what the investment market will be able to deliver are still too high. Savings rates will be forcibly increased. Spending/savings pressures on individuals, under funded corporate plans, and belated legislative incentives will begin to chip away at the problem. The sooner these initiatives happen the better, so that the power of compounding can have a more material effect.

In the investment area, we believe that CornerCap will be able to deliver returns in excess of the 7.5% to 8% market forecast over the next decade. First, there are many stock growth opportunities available in the market that are not priced at 30 times earnings. We believe that our disciplined investment process that incorporates both earnings multiples and earnings growth gives us a permanent advantage resulting in long-term returns in excess of the market.

Secondly, the capitalization-weighted indices (e.g. S&P 500) went through an 18-year period when multiples expanded from eight times earnings to over thirty times earnings. Because of the multiple expansions of these mega-cap stocks, the capitalization-weighted indices have been difficult for most investors to outperform over this period. This has not been the case over the last two years, and we believe that the capitalization-weighted indices will become relatively easy to outperform over the coming years. Reversion to the mean is a powerful force, even when the cycles extend over multiple decades. ▲

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LEARNING FROM ENRON

LESSON 1: WALL STREET RESEARCH

On whom should one rely for investment advice? With the creative accounting that many companies use to beautify their financial statements, it takes an incredible amount of time and effort to understand the numbers. Most investors rely on Wall Street securities firms for this research. These are well-established firms such as Merrill Lynch, Salomon Smith Barney, Morgan Stanley Dean Witter, etc. It is important to understand why almost all of the analysts at these firms had positive ratings for Enron in the months before it went bankrupt. If this were understood, then people would know why CornerCap has never relied on Wall Street research.

The cash cow for Wall Street securities firms is underwriting deals. Research is a loss leader. It is in the securities firms' best economic interest to push their research analysts to support actively the stocks and bonds of the companies that the firms may underwrite in the future. Tout a company that becomes a big underwriting, and the research analyst may receive a significant bonus. Bash a company that shuts the firm out of a big underwriting, and there will be no bonus and possibly no job. This is not complicated; just follow the money. There is no way that these analysts can be totally independent and objective.

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A good example was Daniel Scotto, a bond analyst with BNP Paribas. On August 23, 2001, he lowered his rating for Enron bonds from "buy" to "neutral" and further noted in his research report that investors consider using the sale of Enron securities as a source of funds. For job security, he chose not to rate the bonds a "sell." Mr. Scotto followed up the research report with a conference call where he was more blunt about his recommendation. The phone call was recorded since it was from the trading floor. A few days later, he was told that his recommendations did not seem reasonable and that he was immediately demoted and placed on family leave so he could "cool off." While on leave, the company advised him that he was terminated. There was economic pain and no benefit to Mr. Scotto for his objectivity.

One by one, independent investment research firms have disappeared. Research is now sold or "given away" by Wall Street firms that sell other conflicting products. When markets are roaring as they did during the 1990s, no one feels the need to pay for independent research. In bear markets, investors are more willing to pay for independent advice. We do our own research, and it has always been independent. This philosophy has and will continue to enhance our performance.

LESSON 2: 401(K) ACCOUNTABILITY

When stocks were soaring, so was investors' confidence. Investors were comfortable with risk, especially the risk associated with a heavy concentration in whatever was doing well. Enron was doing well. Employees of Enron were comfortable and pleased with the company stock that had been given to them as a bonus in their 401(k) plan. In fact, some employees even elected to buy more of the Enron stock with their own savings, even though they were already over concentrated in the stock, not to mention the job/salary risk for which they were exposed.

When one of these single stock portfolios crashes, investors look to blame someone else for their concentration risk.

There is nothing wrong with a company (a) choosing to pay its employees a bonus with stock in the corporation and (b) allowing the company stock to be one of the choices available for investment by their employees. As reported in *The Washington Times*, Enron employees had 62% of their 401(k) assets invested in the company's stock. This is not unusual. A few comparisons include Coca-Cola with 81%, Pfizer with 86%, and McDonalds with 74%. There are no complaints on the upside, but when one of these single stock portfolios crashes, investors look to blame someone else for their concentration risk.

When we managed the RJR Nabisco pension fund, a defined benefit plan, we were responsible for the investment performance. The employee's retirement benefit was defined in advance, and the company accepted the investment risk. The primary savings vehicle for corporate employees has transitioned to a 401(k) plan, a defined contribution plan. The retirement benefit is no longer defined in advance. The employee must make his own investment decisions and accept all of the investment risk. Most employees in these corporations do not understand investment risks. They are moving up the learning curve, but, as we have seen with the Enron debacle, the most effective lessons are usually painful.

LESSON 3: DILUTION OR POLLUTION

As our clients know, CornerCap places significant importance on a company's price/earnings ratio (P/E). We want to buy as much earnings as possible for the lowest price. We know the numerator (price), but the denominator (earnings) has become increasingly difficult to define. The reporting of earnings by corporations has gone from fully diluted to fully polluted.

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LEARNING FROM ENRON (CONT.)

Before the speculative frenzies of the 1990s, corporate earnings were reported using generally accepted accounting principles (GAAP). This has changed. As Enron, Arthur Andersen, and others have shown us, there is substantial flexibility in the interpretation of GAAP. Succumbing to the same greed cycle as their stockholders, corporate management created new earnings numbers in addition to the GAAP numbers that they are required to report. These earnings are commonly referred to as proforma or operating earnings, and they normally present a much rosier picture of the company. The usual drill is that there are certain expenses or asset write-downs that management considers "extraordinary," and these are excluded from the proforma earnings, thereby boosting profits. Oddly enough, it is a rare event when there is an extraordinary item that materially lowers profits.

The reporting of earnings by corporations has gone from fully diluted to fully polluted.

Early leaders in these aggressive accounting practices were Amazon and Yahoo. These pioneering profit polluters then did something even more creative. They began highlighting their proforma earnings results in their news releases and publications. The analyst community, always eager to please (see *Wall Street Research*), fell in line with companies' reporting of these generally inflated earnings. With this crack in the foundation, the floodgates opened. Many companies are now being exposed for these ethically questionable accounting practices. We hope the pendulum is reversing and corporate boards and managements will begin to be held more accountable for their accounting. ▲



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