

## SHOCK AND AWE

As this is being written, the war with Iraq appears to be in its final stages. There are many frightening, uncertain events still ahead for our country and economy—secure post-war Iraq, build a new Iraq, help implement an Arab/Israeli peace plan, control government debt and deficits, restart our economy, etc. The list is one of shock and awe, and it certainly elevates the fears of an investor class already shaken by three years of declines in excess of 40% on U.S. equities, as measured by the S&P 500. What is it that can give anyone hope? Have things changed such that fear is now permanent both in our portfolios and on our streets?

Problems (and opportunities) arise when emotions, such as fear, move to an out-of-proportion extreme—high or low. As Sir John Templeton has often said, "The time of maximum pessimism is the best time to buy." Are we at a point of maximum pessimism now? Has fear peaked? We cannot say for sure. But, while the market is still not cheap, we believe that there continues to be plenty of reasonably priced securities available in the marketplace. We still caution that being "reasonably priced" probably means an expected return of 8% to 9% over the next five to ten years and not a return of 10% to 15%. We will talk more about that later in this commentary.

### THE ULTIMATE AWE

In the financial arena, the weapon of mass destruction that must be avoided at all costs is deflation. We believe that deflation has a low probability of

occurring. However, even a low probability is worrisome. Prices for consumer goods (not services) are falling for the first time since 1960. We are in the midst of a profit recession, and corporations are not able to recover by raising prices. In an effort to stimulate the economy, the Fed has cut short-term rates to 1.25%, leaving essentially no more opportunities for easing rates. Indeed, we already finance cars, TVs, appliances, etc. at a 0% interest rate.

Actually, deflation by itself is not necessarily a bad thing. China in the 1990s and America in the early 1950s each experienced declining prices, but incomes continued to rise because productivity increased substantially. The problem arises, however, when deflation is combined with a heavy debt burden, such as we have seen in Japan for over a decade. In the U.S. during the 1920s, we saw a new method of debt-

**T**he weapon of mass destruction that must be avoided at all costs is deflation.

financed consumption in the form of the installment sale. Today, the current debt of choice is the home mortgage, enabling many consumers to take cash out by refinancing or opening a line of credit.

Of greater concern is corporate debt. Corporate debt has doubled since the 1950s and is now approaching 90% of revenues. This worrisome level of corporate debt is reflected in the fact that corporations must offer bonds at interest rates that are historically much higher than the rates on risk-free Treasury bonds. Non-government debt is now over 150% of GNP (gross national product), a level that we have not seen since

SEE PAGE 2

## DO BONDS BUBBLE TOO?

Every financial security that contains a risk premium will go through cycles. Bonds are no exception. The bond market bottomed in 1982 when inflation was at its peak. Of course, bond prices move up as yields go down. In 1982, long-term government bonds were yielding over 14%, which resulted in bond prices being severely depressed. Over the last 20 years, the yields on bonds have been on a steady decline, and the market value of bonds has been appreciating. Are we seeing a bond market bubble similar to the stock market bubble that punished many greedy investors three years ago?

To repeat Stein's Law from one of our pre-bubble-burst newsletters, "If something cannot go on forever, it will stop." Bond prices have been appreciating for over two decades. They will stop appreciating. This will probably happen sooner rather than later—see our lead article in this newsletter about the need to re-inflate to avoid deflation.

Another bubble! Does this mean that investors should avoid bonds? We do not think so. The magnitude of the expansion and explosion of bubbles correlates to

SEE PAGE 3

# SHOCK AND AWE (CONTINUED)

the late 1930s. If companies should have to repay this heavy debt with deflated dollars while profits are on the decline, that is a formula for disaster or, to use the "D" word, possible depression.

We believe that the possibility is remote of the U.S.'s experiencing debt-burdened deflation that could spiral into a depression. While our current economic controls are far from perfect, we are better equipped today to ensure financial responsibility. The Fed has said that, even if the lowering of interest rates becomes ineffective, it has other options for managing the risk of deflation, not the least of which involves printing money. Moreover, on the fiscal side, we are also seeing anti-deflationary efforts to include increased government spending and proposed tax cuts.

Our forecast would be a muddle-through scenario, possibly with a period of mild deflation. The Fed will do whatever it takes to prevent the ravages of a full scale, debt-driven deflation. Corporate debt has already started to decline as businesses try to work through the excesses of the 1990s' bubbles. The Fed will probably hold interest rates down for a while in order to keep housing prices firm while the corporate side recovers. The take-home message from all the above is that we believe we are entering a major new economic cycle.

## CAPITAL SURRENDERS TO THE CAPITOL

With CornerCap's having a foundation rooted in quantitative contrarianism and Graham & Dodd fundamentalism, any forecast that we make will be long term and will include an element of reversion to the mean. We agree with our friends at PIMCO who have recently suggested that the U.S. economy is in the process of making a substantial structural change. However, this change will be consistent with the cycles experienced in our country for over 100 years. This cycle involves the transition of economic power between the private and public sectors.

In the 1960s, the public sector grabbed the power base and maintained this dominant position throughout the 1970s. Let us call this a "democratic" cycle, because it was defined by each person's having one vote, and, in the aggregate, the voters voted for more government. These voters supported more taxes, more entitlements, and a proliferation of governmental controls and regulations. This cycle ran its course by the early 1980s, and the resulting extreme was somewhat predictable, with high inflation, high unemployment, high interest rates, low equity returns, high government debt, etc.—pretty dismal.

The democratic cycle peaked (or bottomed, depending on your perspective) with Jimmy Carter's outgoing administration. Ronald Reagan appeared on the scene

expressing a new course or, rather, a return to the philosophy of earlier cycles: "Government isn't the solution to our problem. Government is the problem." In the 1980s and 1990s, the private sector grabbed the power base. Let us call this the "capitalism" cycle, since the driving force was that each dollar had one vote, and, in the aggregate, the dollars voted for less government and more free enterprise.

We experienced a long period of disinflation as deficits were reduced, government debt declined (as a percent of GDP), business growth and productivity soared, and Wall Street was elated. This cycle ran its course by the turn of the century, having solved all the problems noted above that were created by the democratic cycle. But unbridled capitalism eventually creates its own set of perilous extremes, such as the triple bubble experienced in the late 1990s: equity market overvaluation, excessive business investments, and over-leveraged corporate balance sheets—pretty disastrous.

As we work to dissipate the huge bubbles created during the capitalism cycle, we believe that we will rotate back into a democratic cycle. To ensure that we avoid the primary weapon of mass financial destruction, we at least need to re-inflate prices modestly to maintain a margin of safety. We have already seen government deficits rising and debt increasing. At the same time, corporate profits are starting to rise while corporate debt is declining. If new tax cuts were approved, we would expect them to be broader based than what has been proposed. In sum, there will be more for the man on the street and less for Wall Street. Does this also translate into a dismal forecast for your investments?

## FORECASTING THE DECADE

The market peaked in March 2000. In our commentary that month titled "The Beauty Contest," we addressed the absurdity of market valuations and investor behavior by noting in the concluding paragraph:

**T**his cycle involves the transition of economic power between the private and public sectors. . . . There will be more for the man on the street and less for Wall Street.

"As this commentary suggests, we believe that we are in a unique period in the history of the U.S. 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 10 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."

If we define the market as the S&P 500 Index (including dividends), it declined 40.9% over the next three years (March 2000 to March 2003). During that time, our clients' equity investments dramatically outperformed this index, with most accounts still in positive territory. The forecast we

made three years ago proved true, and our investments resulted in a good above-market return at a below-market risk, as much as we have ever experienced. What about the remainder of the decade, especially considering our transition into the "democratic" cycle noted above? Where will the market be in March 2010, seven years out?

The historic, multi-decade, equity return number that we frequently use for projections is around 9%. For the S&P 500 Index to realize a ten-year annualized return of 9% from March 2000 to March 2010, it would have to return 20% per year over the next seven years. We do not see that happening. Again, our 9% forecast is a multi-decade number and not an every decade number. That return does not work when the starting point is a market peak such as we experienced in March 2000.

However, if we were to assume (1) that the market is currently approaching fair valuation and (2) that the S&P 500 returns 9% over the next seven years, then the total return for the full decade would be zero. Because of the more reasonable valuation of CornerCap stocks and the disciplined process that

we use, we believe that this 9% return represents a reasonable forecast for our clients over the next seven years. However, we continue to be less confident of the S&P 500 Index return since it continues to trade at 25 to 30 times earnings.

Whether we are talking about our financial lives or our daily lives, it is important not to be overcome by fear. The equity market should provide reasonable returns over the next seven years, especially after the three-year adjustment following the late 1990s bubble. With regard to the potential long-term effect on other asset classes, we expect corporate bonds (versus government bonds) to do reasonably well as companies continue reducing their debt and lowering their spread versus Treasuries. Also, some commodities and non-U.S. investments may provide good, relative performance as the U.S. attempts to re-inflate its prices modestly and deflate the dollar.

In contrast to three years ago, most investors now seem to be sufficiently respectful of the fear side of the market. However, the courage of some seems to have gone AWOL. ▲

**I**f we were to assume that the S&P 500 returns 9% over the next seven years, then the total return for the full decade would be zero.

## DO BONDS BUBBLE TOO? (CONTINUED)

the level of risk with the investment. Bonds are not nearly as risky as stocks. Also, we did not recommend avoiding all stocks (just some stocks) at the peak of the stock market bubble, and CornerCap's clients have performed well since then, especially over the first two years of the market crash. Similarly, investors need to be prudent with their bond investments but not altogether absent from this asset class. We will share our recommendations with you.

First, for the average investor, the role that bonds should play in portfolios is one of risk control and not return maximization. Of course, one could "play" with bonds by using leverage, long durations, distress debt, etc., but you will need to read someone else's newsletter for that advice.

Second, investors should avoid long-term bonds. Eugene Fama, the University of Chicago professor and noted market researcher, completed a study of long-term bond returns over a 40-year period ending in 2001. He concluded that the wide variances in their rates of return (i.e., volatility) did not sufficiently compensate investors for the risk incurred.

Third, investors should not hold a concentration in short-term, fixed-income securities, such as money market funds. Our advice about bonds is the same as our advice about stocks: we do not think investors should try to time the bond market, which such a concentration would represent. Studies have shown that investors have failed miserably in their attempts to make these market-timing calls. Other than misguided market timing, the problem with long-term investors' holding a concentration at the short end of the yield curve is two-fold: (1) this is the lowest returning asset class

over time, and (2) the reinvestment risk is significant.

To illustrate the reinvestment risk, a long-term investor concentrated in short-term holdings would have to decide at some point when to extend the maturities in order to increase the portfolio yield. There is no way to know what the yield will be at that point. Today might be a good example. If an investor had moved his investments to a money market fund five years ago, the investments would now be yielding 1% or less.

Extending the maturities in the portfolio today would increase the investor's yield but at much lower rates than had been available in years past. In this example, the reinvestment risk is expensive and totally avoidable.

Fourth, for most investors, we believe that a bond portfolio that ladders the maturities over the short to intermediate term will provide the highest risk-adjusted, after-cost returns over time. These bonds should be of relatively high quality and, if possible, non-callable. The objective should be to hold these bonds to maturity. As bonds mature each year, the proceeds should be used to purchase additional bonds at the longer end of the portfolio, say eight to twelve years.

We believe that the above strategy gives the bond investor a higher probability of success. The laddering strategy will result in (1) an attractive income for the risk incurred, (2) some price appreciation on bonds purchased as they migrate down the typical yield curve, and (3) a smoothing out of the reinvestment risk. We frequently argue that excitement is the enemy of success with stock market investing. The same is true with bonds, except the excitement needs to be ratcheted down another level or two. ▲

**B**ond prices have been appreciating for over two decades. They will stop appreciating.



*The CornerCap Information Technology Group works together on the development of the next generation of our equity research system, Fundametrics®. From left are Sean Durity, Laura Hull, and Huett Britt.*



*Jeff Moeller is responsible for trading securities for our clients' accounts. Jeff also serves as a research analyst and is taking Level 3 (final level) of the CFA exam.*



The Peachtree, Suite 1700  
1355 Peachtree Street, NE  
Atlanta, GA 30309  
404-870-0700

Thomas E. Quinn, CEO, CFA  
Gene A. Hoots, Chairman  
James C. Carr, President

Portfolio Managers:  
Richard T. Bean, CFA  
Douglas M. Dougherty  
Bradford S. J. Young, CFA

First Class  
U.S. Postage  
PAID  
Kennesaw, GA  
Permit No. 555