

(WHEN) WILL THE MARKET COME BACK?

We like to use our commentaries to answer the questions that are being most frequently asked by investors. We try to be candid with our answers, even when no one wants to hear the things we feel need to

market fall?" While we saw the wave coming and knew it was big, and said so, not many wanted to listen, although we considered the indicators to be very clear.

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be said. The problem is that investors always seem to be asking the wrong questions, and there is an abundance of finance and media types whose enthusiastic responses imply validity to the questions being asked.

With most investors in a state of shock, they are asking two questions that speak to their three years of pain and their desire for relief: How could I have not seen this coming? When will the market come back? Regarding the first question, we would argue that reasonable people should have known that when stocks trade at three times the average market multiple to infinity, the real question becomes, "When will the

Regarding the second question, historically, at the bottom of severe market downturns, most investors do not ask "when" the market will come back but "if" it ever will. To address this second question better, we need to get our "ifs" and "whens" straight. We need to review this emotional roller coaster and suggest a better way to ride the equity market.

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WHERE HAVE WE BEEN?

From the market's peak in March 2000 through year-end 2002, the S&P 500 was down 42% and the NASDAQ was down 74%. The market has declined

MISPLACED MOTIVES

"Buyer beware" is always good, whether one is buying a stereo or a stock. Stock salesmen are much better paid than stereo salesmen, and the effectiveness of stock salesmen is reflected in their compensation. As a sampling, the CEOs of Oracle, AOL Time Warner, Cisco, Dell, Disney, JDS Uniphase, and Siebel Systems each received well over \$100 million from exercising stock options given to them by their companies. These CEOs are probably highly motivated to sell their companies to the Wall Street research analysts and anyone else who might create more buyer interest. These companies have all declined 50% to 95% in value from their peak. Why do corporate boards choose to reward failure?

Over 80% of the billions of dollars realized from employee stock options went to senior executives, primarily those of the largest S&P 500 companies. According to *The New York Times*, last year 47 executives in the 100 worst performing companies in the S&P 500 took home at least \$5 million each by selling company stock or options that were given to them as incentive compensation. Are these boards motivating their managers to create long-term value for their shareholders or primarily to promote their

company's stock to the investing public in order to reach some target price?

In the late 1990s, the executive compensation practices evolved to a winner-take-all lottery. It began with the idea that issuing stock options would allow these executives to walk in the same shoes as the other shareholders. It ended with an infectious greed that contaminated good judgment. Instead of motivating hard work to build long-term value for the company, it encouraged excess risk, creative accounting, and, in a number of cases, fraud.

And worst of all, the get-rich-quick scheme worked, and it is legal. As suggested above, many of these executives oversold their companies to the investing public. Investors bought, temporarily pushing the stock prices up to the option exercise prices, and the executives cashed out. The investors owned a piece of paper worth less than half of what they paid for it, and the executives quietly took the investors' cash to their local bank. Even with all that has been written, we do not believe that average investors understand what they were sold or know what they funded with their hard earned cash. Few of them have followed the money trail.

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(WHEN) WILL THE MARKET COME BACK? (CONTINUED)

for three consecutive years, and the last time that happened was during the Depression. We are pleased that CornerCap's equity investments declined during only one of these three years (2002) and that our three-year performance was up to only slightly down, depending on the specific client objectives. That was yesterday. Our focus must always be on the future.

The investing community tends to define a bear market as a 20% decline from a previous high. Applying these bear-market criteria to the changes in the S&P 500 Index, we have experienced three separate bear markets over the last three years. They were as follows: (1) March 2000 to April 2001, down 28%; (2) May 2001 to September 2001, down 26%; and (3) January 2002 to July 2002, down 32%. We just barely missed a fourth bear market between August and October of 2002, down 18%.

Excluding the one-day market crash on Black Monday (October 19, 1987), we had not experienced a bear market in the U.S. since 1982. Over this 18-year period (1982 to 2000), we were building up huge excesses, even though the economy was performing reasonably well. These excesses involved not only inflated stock prices but also production over-capacities and bulging corporate budgets. We are not sure how long it will take to work off these excesses, but as discussed below, we do not appear to be there yet.

Another characteristic of having three bear markets in three years is the number of false starts we have seen for the next bull market. During the 42% decline in the market since March 2000, we have also experienced three relatively significant market upturns. Why so many false starts, and why have we not seen the type of panic selling that is typical of the capitulation phase of a market bottom? Part of the answer may relate to the proliferation of hedge funds that is fueling a new breed of short-term investors. The hedge-fund managers may be faster traders than we long-term investors, but we doubt that they are any better at figuring out when the change in direction will be more lasting.

WHERE ARE WE NOW?

Having experienced these new post-Depression records, one would think that we are nearing a market bottom. Of course, not many thought about those statistical aberrations on the upside. In 1999, we finished our ninth consecutive year of positive market returns (our prior record was five consecutive years!) and completed an 18-year bull market run (another record). We do not know exactly when the bottom will occur or whether, in fact, it occurred on October 9, 2002. What we do know is that the market is not cheap by any stretch of the imagination, and more bad news for investors in 2003 is certainly possible.

Rather than market timing statistics or the emotions of fickle investors, CornerCap primarily looks at market valuation levels when the talk turns to market extremes, whether they are high or low. Using approximate historic

values, the market has been priced to average around 16 times earnings over time and at market bottoms around 13 times earnings. Most research analysts are computing the current market multiple at 18 and categorizing it as either cheap or reasonable. While this is still not cheap by our yardstick, it is certainly more palatable than it was three years ago when it was at least double that ratio.

Another concern of ours is the reality of the 18-times-earnings number that Wall Street is computing and promoting. This ratio is based on next year's earnings (2003), and just as these prognosticators did a year ago, they are including a healthy increase from the 2002 earnings. As witnessed last year, this projected growth rate is very uncertain. There are more problems. We believe that the 2002 earnings number from which the growth rate is applied is overstated. With the blessing of their accountants, companies have been aggressively overstating their earnings, excluding many things that are negative and leaving in the good stuff. The 18-times-earnings number for the market also excludes companies with negative earnings, and there have been a number of those in 2002.

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Maybe earnings are depressed now or at least reasonably reported. Maybe inflation is permanently tamed and a higher market valuation is justified. Regardless of the "maybes," or the complexities that Wall Street works to create, or how much the market has already dropped, we believe that the S&P 500 Index is still not cheap. And emotionally, we are not sure that investors have reached the depth of despondency that is needed to reflect a true market bottom. When will the market come back? Probably when investors drop the "when" from the question.

WHERE ARE WE GOING?

For long-term investors, this is not a good question. It does not matter where the market is. Most investors should have a long-term allocation to the equity market, and they should stay with that allocation. In the short term (say, less than five years), the market will always move up and down the emotional roller coaster, cresting and bottoming at unpredictable points along the way. The various sellers of stocks or investment information will always be fueling the hope that they have the answers for this time and set of complex factors. Today's complexities have added to the market's volatility and include many critical matters, like terrorism, Iraq and North Korea, oil risks, the languishing economy, proposed tax legislation, etc. Some analysts may accurately predict some of these issues. A few may even successfully predict how the market will react to these events. But, what we cannot predict are the select few analysts who happen to get it right this time around.

Because of the various costs incurred (spreads, commissions, taxes), long-term investors will never win by trying to time the unpredictable emotions of the market. And at this time in the market with the after-tax yield on

money market funds in the 1% range, why would a long-term investor give up the higher dividend yield on equities and assume a zero or negative growth rate for the coming five to ten years? This logic makes no sense to us.

How do you win? Many people believe that investing is very complicated today. We disagree. It has never been that complicated. As Warren Buffett said at the last Berkshire Hathaway annual meeting, "The most important skills for successful investing are realism and discipline . . . not intelligence and an ability to work with numbers." There is no magic formula; you simply buy a diversified group of businesses that sells at a price that is reasonable when compared to current earnings and projected cash flows. Of course, success is predicated on having patience, i.e., giving the process time to work.

Successful investors, even Buffett, have learned that all selections do not work out as planned. That is why we diversify, to limit those things that we cannot control. That is also why we look for stocks that are priced low enough to have a margin of safety. Market emotions are usually the tricky part. An ability always to detach one's self from the crowd is invaluable, and this is the one skill that may be more innate than learned. It would be difficult to survive at CornerCap without this mindset.

Putting the above philosophy into practice, let us review CornerCap's current stock holdings. Our current large- to mid-capitalization stocks are trading at 11.8 times 2002

estimated earnings. This compares to our estimate of a realistic market multiple in the range of 25 to 30 times earnings and reflects over a 50% discount to the market. Our stocks are yielding 2.7% versus 1.7% for the market. For our small-cap stocks from which we have a larger pool to select, the multiples are even better. With this margin of safety built in and with these yields, do we really need to agonize over how high or low the market might be?

What is truly interesting is how consistent the valuations of our holdings have been over the years. At the market peak in the spring of 2000, our stocks were still priced at 12 to 14 times earnings. So long as our clients are long term and we are able to buy stocks in this range, we will win for them. All we have to do is stay stubbornly with the discipline. However, every sound bite out of Wall Street argues for change, action, response, exception, complexity, etc., i.e., just do something so we can feed this massive machine we have built.

The principals of CornerCap have been managing client assets for over 23 years. We have used roughly the same process, and we have realized relatively stable returns through the gyrations of the market. If you prefer the thrill of the roller coaster ride, you will find the shows are better in Las Vegas. If you prefer to realize higher returns while on a smoother ride, you will need to block out the noise of Wall Street and just put on the headphones and turn up Lawrence Welk. ▲

MISPLACED MOTIVES (CONTINUED)

Pay attention: this is not a problem about a bubble that has come and gone. This has still not been fixed. Have we not learned our lesson? How much of a "commission" do we want these senior management salesmen to be paid for temporarily getting up their stock price? Legislators, regulators, and auditors are making a lot of noise about fixing the effects (correcting accounting irregularities, fining Wall Street research firms, convicting top executives of fraud, etc.) but nothing about fixing the cause. The top executives continue to defend the merits of using equity option incentives for themselves and their key lieutenants, and they have a point.

We believe that most corporate executives are quality, talented people. But when there are no controls on their being able to bestow unimaginable wealth on themselves, they will again, maybe with better camouflage than last time, try to reap the harvest from the seeds that we have allowed them to sow. We should not assume again that self-interest dictates prudence. We should not assume again that equity ownership through the leverage of stock options aligns management and shareholders' interests. We believe that the responsibility for righting these wrongs is with corporate boards.

CornerCap's board is distributing equity ownership each year to key employees of the firm. These owner/managers will not realize substantial wealth from their equity ownership without holding their shares for a very long time. While share ownership may make them wealthy one day, the wealth will result from building long-term value for CornerCap's clients and not from exercising company options almost on an annual basis. If boards begin forcing long-term holding periods on

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executives (and themselves), this will make them focus on long-term results.

These corporate board members clearly want to restore public confidence in their companies and distance themselves from any existing or potential scandals. Even though the need for change is clear, we are not optimistic. Few corporate boards have been willing to defy the wishes of their CEOs in the past. The opportunity for immense wealth is clear and still present, and those in control will not want to give it up. Absentee ownership is difficult. We investors are the owners. The corporate boards are accountable to us. We will do what we can at CornerCap to continue addressing this problem, not the least of which is to vote the corporate proxies diligently in our clients' best interest. ▲

CORNER CAP HIGHLIGHTS

We are pleased that Terri McGinnis recently joined the firm as an operations assistant. Grace Wright was promoted to Director of Administrative Services in recognition of the standards she has set for the firm for administrative services to our clients. Jeff Moeller, a trader/analyst for the firm, successfully completed level two of the CFA (Chartered Financial Analyst) program, and he hopes to complete the final level this year.



Investment Committee meeting. From left: portfolio managers Doug Dougherty, Richard Bean, Tom Quinn, and Brad Young. (Not shown: trader/analyst Jeff Moeller and president Jim Carr)



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