THE CORNERCAP® INVESTOR®

www.cornercap.com

NOVEMBER 2004/VOLUME 26, NUMBER 3

# THE *CHARACTER* OF AN INVESTOR

In our last newsletter, written on the plane flying back from the Berkshire Hathaway (B-H) annual meeting, we talked about the successful investing of Warren Buffett. One of our points was that it was a flawed strategy to try and buy the B-H shares or even to copy Buffett's specific investments, even though we adhere to many of his investment principles. We noted that Buffett was but one of a mosaic of our investment heroes. The centerpiece of that mosaic has to be Ben Graham, Buffett's investments professor at Columbia University and the author of *The Intelligent Investor*, first published in 1949.

## INFORMED FORMULAS

In these turbulent times, we can find strength by reflecting back on the sources of our investment strategies. Mr. Graham is considered the father of security analysis, and his text is considered the "Bible" in our industry. Graham presented a series of formulas that, if used with good data and a strong discipline, would essentially assure an investor's success over time. But, it is not as easy as it sounds. As Graham once said, "My books have probably been read and disregarded by more people than any book on finance that I know of." People prefer pursuing their own passions rather than the principles of past legends.

> You are neither right nor wrong because the crowd disagrees with you.

Like Graham, we have a series of formulas that we use to ensure that we will be successful investors over time. While we are relatively certain that we will not be successful all the time, we now have 25 years of success using the same basic investment philosophy and process. Our formulas are not overly complex; neither were Graham's. The magic is not in the sophistication of the formulas but in the logic of their selection, the quality of the data, and the consistency of their application.

Some of our formulas are essentially copies of Graham's and some are not. While Graham's investment concepts are timeless, specific calculations must be updated to reflect the evolution of the business environment. But, just as Graham did, we recognize the problems that many investors have in this area. Quality investment research requires that one has a clear understanding of the past and is realistic about the present. However, simple principles can be problems in practice.

## DEFORMED FORMULAS

It is amazing that, in the pre-computer times of over a half-century ago, Graham saw and clearly articulated the problems with investment research, problems that research professionals continue to disregard today. We will spare you the details, but he was the original skeptic of **back-tested formulas**. Even with modern-day computer power, it is next to impossible to go back in time and know exactly what information was at the investor's disposal for making an investment decision, and then to measure the impact of those decisions

SEE PAGE 2

## MANAGEMENT SUMMIT

*In September, CornerCap professionals met at Brasstown Valley Resort in Young Harris, Georgia, for a management summit: From the left, first row: Jim Carr, John Hackney, Tom Quinn, Grace Wright; second row: Anno Hardage, Doug Dougherty, Gene Hoots, Richard Bean*

accurately using "paper money." Back-tested results are meaningless at best but are more typically counter-productive. At CornerCap, our Fundatmetrics® Equity Research System has retained over 20 years of real time results for our most senior formulas, so it is easier for us to continue to shy away from the temptation of back testing.

Graham also recognized the problem with "**survivorship bias**" long before the term existed. A current example of survivorship bias is the Morningstar database of mutual funds. It is difficult to compare the historic performance of a fund in that database because Morningstar only has the mutual funds that have survived. The closed or merged funds, presumably the worst performers, are no longer shown in the database and their performance has been forever erased. Because of our modern-day need for speed and greed, investment researchers continue to assume away these destructive data problems.


> Thus, a return for a specific time period can be relatively meaningless to investment reality, but it can be oh so meaningful to marketing reality!


Graham also preached about the problems with **time-period dependency.** For example, investment returns and other numbers can be changed dramatically simply by shifting the beginning and ending dates for a series of data. In investment research, the analyst becomes the sponsor of a new formula that he is convinced will add value to the investment process. The analyst then mines the research data until he finds the time series that supports his case. We see this manipulation of beginning and ending points all the time in the marketing of financial products. But, when this manipulation takes place with the investment research (versus marketing), it is the basic investment product that is being damaged and not just the targeted prospect for the product.

While investment researchers abuse this concept of time-period mani-pulation, the Wall Street peddlers are the masters of its misapplication. We have seen this phenomenon with our own investment returns, especially as we market to the institutional community with its focus on relative returns. With a three-year return, five-year return, or whatever time period, simply moving forward and adding a new quarter and dropping off the beginning period quarter can move your returns from below average to above average. Thus, a return for a specific time period can be relatively meaningless to investment reality, but it can be oh so meaningful to marketing reality! Hence, we have Graham's early admonition about the misuse of time dependent data.

## FORECASTING OUR FORMULAS

The market in 2004 has been somewhat uneventful. While we cannot say where we are in the current cycle, we do believe that the relative swings will not be as dramatic as we experienced in the late 1990s tech bubble. We will also predict that when a swing comes, we will be unable to define clearly the cause until we are well into it. Moreover, we will not know when it will end. Extreme market dislocations are typically motivated by the masses, and mass psychology is always hard to predict.

Another prediction that we cannot make is how much longer the market will favor CornerCap's style of investing. We do know that, during those times when we are out of step with the market, some clients, consultants, and prospects will criticize us. This criticism may be about our returns, but it will also be about our apparent disregard for the immediate thrills and chills that are taking place in the market. We share Ben Graham's thoughts on the irrelevance of this market "action." He said, "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and your reasoning are right." Therefore, what we need to be doing is continually updating our formulas and following our disciplines and not following the market noise that is being mislabeled as news.

## THE INDEPENDENCE PARADOX

Graham's central theme in the above quote and throughout much of his text is ***independence***. Most investment advisory firms like CornerCap consider themselves independent. This is a relative term. We would argue that most firms are not independent. It is an odd behavioral paradox. In general, investment advisors know that independent thinking will significantly enhance their returns over time. The purchasers of the investment advisor's products also know and agree with this principle. Since known by all, what's the problem?

> The paradox is that the buyer and seller have colluded to turn a basic advantage (independence) into a basic disadvantage (dependence).

Independence, even among experts, is forfeited in curious ways. In the institutional world, the consultants and plan sponsors teach independence in the course lesson, but on the final exam, they want to know your information ratio, correlation an standard deviation a compared to the benchmark index that you have been assigned. It is acceptable to be at or above these measurements and maybe even slightly below, but no time period should be significantly out of line. This is one of the means used by the consultant to limit risks, both financial and emotional downside risks.

From an investment perspective, it is important that the investment advisor always behave in an independent manner, which means that these relative-to-benchmark measurements should be disregarded in the investment process. The advisor

should only focus on valuation and risk. In other words, being independent means that the advisor must accept periods when he totally flunks the exam.

Of course, the more dependent the advisor becomes on business from the consultant(s), the more he will do to ensure that he never flunks the exam. This benchmarking process ends up handicapping investment advisors and driving them toward mediocrity. Stated another way, the institutional buyer is forcing the seller, i.e., the investment advisor, to compromise his independence. The paradox is that the buyer and seller have colluded to turn a basic advantage (independence) into a basic disadvantage (dependence).

As we learned from "portfolio insurance" in 1987, the bigger cost may be the exit fee assessed when the fans simultaneously realize that the game is over and that there are fewer exits than anyone ever imagined.

Graham made the point that investment professionals should not focus on creating the optimal investment results for clients but rather on investments that are **psychologically feasible.** In today's world, we translate this to mean that the consultant must properly assess the client's psychological risk profile and make sure that the investment results stay within that relatively narrow range. This ensures that the client can stay the course over the long term.

Maybe the most important term in his original book, *The Intelligent Investor*, was his definition of "intelligent." He wrote, ". . . the intelligence here presupposed is a trait more of the character than the brain."

Maybe trying to find a simple solution to the independence paradox has elevated the attraction of hedge funds to the investment oversight world. This approach could also be psychologically feasible for the client. Just carve off a percentage of the assets for the hedge fund/alternative asset strategies, diversify those strategies to some degree, and let them swing for the alphas. Maybe this is the market's way of pricing out the cost of independence. It still seems entirely too rich based on how we value investments—fees, leverage, risks, turnover, illiquid, non-transparent, track records, etc. As we learned from "portfolio insurance" in 1987, the bigger cost may be the exit fee assessed when the fans simultaneously realize that the game is over and that there are fewer exits than anyone ever imagined.

## An Investor's *Character*

As we coasted through the calm waters for the first three-quarters of the year and into the choppy seas that we seem to see on the horizon, it is beneficial to hone our navigational skills by studying the great masters whose principles have weathered the test of time. In our opinion, Ben Graham was the most proficient, all-around teacher, mastering both the academics and the practical aspects of investing.

Maybe the most important term in his original book, *The Intelligent Investor*, was his definition of "intelligent." He wrote, "...the intelligence here presupposed is a trait more of the character than the brain." He was not talking about smart, shrewd investors with high IQs. By "character," he was talking about matters such as independent thinking, discipline, patience, self-control, a desire to learn, etc. It is these characteristics and not brilliance that make an investor intelligent and most likely successful.

---

# Who's Being Taxed?

As we suffered through the recent Presidential election, both candidates trumpeted many arguments and statistics. While election-year statistics are easy to challenge, the facts are the facts. Based on the most recently available information from the US Treasury (2001 tax returns):

**The top 1% of taxpayers paid 34% of all individual income taxes.**
**The top 33% of taxpayers paid 53% of all individual income taxes.**
**The top 50% of taxpayers paid 96% of all individual income taxes.**

The tax legislation enacted some time ago is projected to make the above progressive tax payments even more extreme, slightly reducing the percentage of taxes paid by lower income taxpayers and increasing the percentage for higher income taxpayers. Those who can afford to should pay more, and that is clearly reflected in the data. "How much more" is over what those people on each side of the aisle keep wrestling.

# New Investment Professionals

ANNO HARDAGE

We are pleased that Anno Hardage recently joined the firm as portfolio manager and director of client service. Anno comes to us from the wealth management side of a local investment firm. She has an MBA from Georgia State and is enrolled in the Chartered Financial Analyst program. We are excited to have Anno at CornerCap and enjoy introducing her to our clients.

JEFF MOELLER

In September, Jeff Moeller joined the firm as portfolio manager/research analyst. He had previously worked for us as a trader for several years, and we are pleased that he has rejoined the team. Jeff is a Chartered Financial Analyst (CFA) Charterholder and a graduate of Oklahoma State University.

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

PRESORT
FIRST CLASS
U.S. POSTAGE
PAID
KENNESAW, GA
PERMIT NO. 555

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

Portfolio Managers:
- Richard T. Bean, CFA, VP
- Douglas M. Dougherty, VP
- Anno M. Hardage
- Jeffrey P. Moeller, CFA