THE CORNERCAP INVESTOR®

www.cornercap.com

SEPTEMBER 2005/VOLUME 27, NUMBER 3

Doug Dougherty On "Why I Joined CornerCap"

Last quarter, Tom Quinn broke with tradition and identified himself as the author of the newsletter article titled, "What Am I Doing Here?" Now that the precedent has been set, I thought that I would write an article along the lines of, "Why I Came Here." Those of you who are clients have reviewed your options and made the decision to use CornerCap as your investment advisor. I went through the same decision-making process several years ago in my search for a portfolio manager position in an advisory firm. I undertook a study of the key characteristics that should be considered when making a decision of such importance. Having made my decision, I wanted to share my thoughts with you, and, hopefully, for our clients, the end result will reconfirm their decision to join CornerCap, just as it has for me.

The Four Ps

To me there are four key characteristics that will provide all of the information necessary to determine the true measure of a firm. The first characteristic is people. People are responsible for the investment philosophy, decisions, processes, client service, and culture. The next characteristic is philosophy. A firm's investment philosophy determines the overarching investment framework and style, as well as the mindset and attitude of the organization. The next characteristic is process. The processes established by a firm enable it to implement the investment philosophy and critical business functions. A firm's discipline in following its processes determines the level and consistency of results. Results are measured by performance, which is the final characteristic. Performance reveals a lot about an organization, and is the test of time of the combination of a firm's people, philosophy, and process. Now, I will briefly describe each of the four Ps as they relate to CornerCap. I apologize in advance for touting my decision to join CornerCap—it was a big decision for me.

People

The people in an investment firm are the most valuable asset of the firm, and the people at CornerCap are no different. I have found them to be a qualified, disciplined group of professionals, which is not unusual for a successful investment advisory firm. The depth of experience is significant, with our two cofounders' being the most seasoned, each with investment backgrounds spanning over 25 years. The remaining senior investment professionals (including me) each have an average of over 10 years of experience, and the entire investment team has weathered bull, bubble, and bear markets. Again, these traits are not unique to CornerCap, but they do indicate a substantial level of real world "time in the trenches."

Along with shared investment experience, there is a diversity of academic credentials among the professionals at CornerCap. The breadth of backgrounds on the investment committee includes accountants, an attorney, engineers, and finance professionals. Every one of CornerCap's investment and business processes have been shaped by one or more of these disciplines, and each of these backgrounds adds a unique facet to the

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Mutual Fund Misconceptions

Over 90% of CornerCap's assets under management are in private accounts for high-net-worth individuals and institutional clients. The remaining assets, less than 10%, are in a mutual fund company that we started 13 years ago. We manage three CornerCap mutual funds: a small-cap fund, a balanced fund, and what we call a contrarian fund.

We set up these funds in order to serve friends and relatives of the firm and of our private clients. We have chosen not to market these funds actively through the large brokerage networks, primarily because these networks are expensive, and, one way or another, the client ends up paying the expenses. Our funds have performed well; they are commission-free to trade at our fund company; and they have no loads or 12(b)1 fees. Over time, our funds sell themselves by word of mouth from our clients.

> **Most people believe that mutual fund companies are primarily focused on investments. We disagree.**

Having been in the mutual fund business since the early '90s, it is interesting to observe the misconceptions that most people outside of the business have about mutual funds. Most people believe that mutual fund companies are primarily focused on investments. We disagree. We believe that most mutual fund companies' first priority is <u>marketing and distribution</u>, the principal source of new REVENUES. They focus on building whatever flavor of funds buyers

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culture at CornerCap. The atmosphere is a collegial one, and yet at the same time, there is a seriousness that reflects the nature of assuming the role of trusted advisor. This seriousness is reflected in all of our actions, from the way that we answer the phone, to our formal business attire.

In addition to the depth and breadth of experience, I have also noticed a depth of capability and breadth of talent. While one of our cofounders, who is also the chief investment officer, has veto power over any stock, the responsibility for stock selection, research, and maintenance of our holding lists has been passed down to the vice president level. We in turn are taking time to nurture and groom the next generation, in order to maintain consistency and continuity in our investment philosophy and process. There is similar depth in client service capabilities, as well as talent in the operations, administrative, and information technology functions. Collectively or singularly, these attributes are impressive, but nothing that I have mentioned about people thus far is by itself a key differentiating factor between CornerCap and other investment advisory firms. The real difference is the collective dedication to the CornerCap philosophy.

PHILOSOPHY

I ascribe to the investment philosophy at CornerCap: contrarian, value-based, bottom-up and fully invested. Those of you who are our clients can by now probably recite chapter and verse on our philosophy. For the benefit of others, we do not believe in following the herd (picture lemmings following each other over the edge of a cliff). The collective "wisdom" is usually wrong, as the market tends to overreact to short-term events, real or perceived. Long-term, the "safe, can't miss" investments that everybody must own (i.e., the Nifty Fifty in the '70s, Oil & Gas LPs in the '80s, technology stocks in the '90s) usually turn out to be the biggest losers. Fear and greed are the culprits, as fear causes prices to fall disproportionately on bad news or poor results, and greed causes prices to rise enigmatically above any rational valuation of the underlying fundamentals. Greed drives people to invest at the top, while fear will keep them on the sidelines after the market bottom. A contrarian nature—going against the conventional investment wisdom—will enable one to avoid these pitfalls and win over time. However, being contrarian is not unique.

The philosophy is also value-based, and the investment process seeks to identify stocks with attractive relative valuations. When buying a stock, what you are really paying for is the stock's stream of cash flows, in the form of dividends, share repurchases, or capital appreciation. As value managers, we are extremely sensitive to how much we are willing to pay for a company's cash flow stream (in contrast to growth managers, who are not price sensitive, as long as the cash flow stream is projected to grow). This value bias permeates all of our investment decisions, including how much we pay for commissions and research. We also adhere to a bottom-up philosophy, which simply means that we begin the stock selection process by searching for unrecognized value at the individual stock level (in contrast, a top-down approach begins with a macro-economic forecast, leading to an economic sector or theme, then to an industry, and finally to stocks within the industry). The bottom-up process offers a simpler, more consistent approach to identifying investments that have the opportunity to be successful in any economic environment.

I also liked the CornerCap philosophy, to remain fully invested in long-term assets at all times. Experience has shown that while it may be possible to time a market top or a market bottom correctly, it is virtually impossible to do both consistently. This skepticism of market timing is another manifestation of the firm's contrarian attitude. Indeed, all four of the philosophical tenets are infused into the mindset at CornerCap and apply not only to investments but also to client service, portfolio management, systems development, and operations. Does this philosophy of being contrarian, value-based, bottom-up and fully invested by itself differentiate CornerCap from other firms? Not entirely, because you must also examine a firm's consistency and discipline in adhering to its philosophy. CornerCap's processes are what make consistency and discipline possible.

PROCESS

I found that the central component of the investment process at CornerCap is the independent, internal research, which consists of a quantitative module and a qualitative module. The quantitative module, called Fundametrics®, receives input data from independent database and forecast services, and utilizes contrarian, value-based algorithms to rank the universe of stocks. These rankings identify the stocks that go in to the "buy" candidate pool, which contains the top 30% of stocks from the universe. Stocks are then selected for purchase from this candidate pool by the qualitative module, which includes analysis of the company's financial statements and SEC filings, an evaluation of the business model, determination of industry dynamics, examination of management's track record, and consideration of other factors, such as ongoing litigation or regulatory issues.

The validity of the assumptions that are used in CornerCap's quantitative and qualitative analyses are constantly evaluated. Over time, the results of the quantitative ranking system and qualitative analysis procedures consistently identify stocks whose prices typically do not reflect their intrinsic value. The quantitative ranking process also measures when a stock becomes overvalued and should be sold. The holdings are monitored on a weekly basis, and when a stock's ranking falls into the overvalued range, it is sold. This process enables CornerCap to maintain its investment discipline.

CornerCap employs a discipline to managing portfolios, which begins by equal weighting all of the stocks in a portfolio. Then, as a stock's price rises above its target threshold, CornerCap

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"trims" (sells a portion of) the holding to maintain the equal weighting. Conversely, if a stock's price declines below the target threshold and the research indicates that it is still attractive, we "round up" (purchase more) to bring the weighting back in line. By following this process, CornerCap is consistently buying low and selling high. There is also a consistent approach to fixed income: purchase quality bonds with short- to intermediate-staggered maturities, and hold each issue until it matures. The proceeds from maturing positions are then reinvested at the prevailing market interest rate, which minimizes interest rate risk and captures the typically higher yield at the long end of the laddered maturity range. Do all of these processes make CornerCap unique? To answer this question, we need to examine performance.

Performance

You can glean a lot about a firm's people, philosophy, and process from its performance. However, you must first examine the quality of performance in order to make a successful assessment. Quality refers to consistency of results, which can be determined by examining each of the calendar year results in the performance history. Firms that follow a successful investment philosophy and well-defined process will tend to have consistent results. It is amazing to see how just one or two really good years can make a 5- or 10-year average annual return appear attractive. Quality also refers to the nature of the reported results. For example, CornerCap reports AIMR-audited results, which indicates that the firm follows the rules and guidelines established by the CFA Institute (formerly the Association for Investment Management and Research) for reporting investment results and that these results have been audited by an independent accounting firm. Audited performance ensures that you are not just seeing the results from the best performing account or an account that is not representative of the firm's investment style.

Once you are satisfied that the results are real, you can then begin to read the history of the firm through its performance. In examining CornerCap's annual results, you can see that the firm employs a value approach to investing. Results trailed the major market indices in 1998, when growth stocks were in favor, and again in 1999, as the technology bubble began to hyper-inflate. While those years were uncomfortable for the firm, CornerCap did not change its stripes, and the vindication came in 2000 when the bubble burst. The firm's equity investments in both 2000 and 2001 were up significantly, while the broad market indices all posted large negative returns. We posted negative returns in 2002 (but were above the benchmarks) and have continued to post solid performance in 2003 and 2004.

There will be other times when CornerCap's results under-perform the benchmarks. But you can be certain that CornerCap will continue to follow its investment discipline, regardless of the market forces or pressures of the day. To me, this speaks volumes about the people, philosophy, and process at CornerCap, with which I am proud to be associated. This analysis reconfirms my decision to join CornerCap, as I hope that it has for those of you who are our clients, as well.

Mutual Fund Misconceptions (Continued)

are demanding and maximize selling whichever funds have the hottest returns.

The next priority for mutual fund companies is administration and compliance. These obligatory COST items are a function of having numerous shareholders, a requirement for daily pricing of the funds, and heavy regulatory requirements, many of which have been imposed because of recently reported abuses with several of the large fund companies.

Of course, another priority of mutual fund companies is investments. All mutual fund companies would like to perform well with their investments. However, in the world of investments, when the sellers rather than the "manufacturers" (i.e., investment folks) set the rules, the buyers get hurt. Bad things start to happen. For example, just at the wrong time, investment strategies are changed, portfolio managers are changed, cold funds are merged into hot funds, costly selling arrangements are created, etc.

Unlike other businesses, in the investment business, we believe that we must be aware of the need to protect clients or prospective investors from themselves. Consistently over time, investors have demanded new products and investment changes based on their emotions rather than the investment probabilities. Today it is hedge funds. Yesterday it was tech stocks. Before that, it was mega-cap stocks, and so on.

In the long run, we believe that our firm and our clients will both be better served by a "seller beware" (not "buyer beware") approach to business. At CornerCap, we have taken the following prioritization of the key mutual fund functions to a new level.

- We are solely focused on investments.

- For the administration of our mutual funds, we have now completed outsourcing all of those responsibilities to ALPS, a mutual fund administration firm located in Denver. To our fund shareholders, this change should not be noticeable. (Actually, it will be an improvement as soon as our new Internet capabilities are connected in the next few weeks.) To our firm, this change will help us to stay focused on investments, our most mission-critical function.

- For marketing and distribution, we will continue to rely on word of mouth from our existing shareholders. For our shareholders, this serves to hold their costs down. For CornerCap, again, we can stay focused on investments. Every other mutual fund company out there would be wholly unimpressed with this marketing plan, and rightly so, but we have grown nicely over time and believe that this will continue.

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CornerCap Highlights

CornerCap suffered one major loss by outsourcing our mutual fund administration. Karen Quinn, our fund accountant and transfer agent, has left the firm to pursue other career opportunities. One of those opportunities, shown here with Karen, is Jason Anderson whom she will be marrying next February. Karen did an excellent job for CornerCap over the last 5 years, and we will all miss her (especially our CEO).

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