

THE WEALTH TRANSFER FUNDS

In addition to researching stocks and constructing portfolios that we believe will be successful for our clients, we also enjoy being students of the market and the behavior of investors. We are now on the backside of our third decade in this search for a greater knowledge and understanding. We have known and worked with some of the best people in the investment business, and we have witnessed some of the worst.

Fools in the Pool

The investment business has larger pools of liquid assets than most other businesses, and access to these assets attract many talented professionals, ranging from the productive to the destructive. There is no shortage of examples of undesirable professionals (Enron executives, sell-side analysts, tech bubble promoters, insurance and mutual fund scoundrels), and we have written numerous articles about their behavior in the investment market.

The current business of choice for many of these talented professionals is hedge funds. The pools are large, the rules are loose, and the fools are there for the taking. Most investment professionals are ethical people, and many of them are truly talented, but their motivations have too much of a fast deal feel. And, most hedge fund clients are not fools, but they see a quasi guarantee and new economics that are nowhere near reality. We have traveled this road before.

Our hope for the hedge fund mania is the same as the hope we expressed during the tech bubble, which is that

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once investors awaken to the disappointment that will occur, the end will come more as a whimper than a wallop. With tech, our worst fears were realized. With hedge funds, we do not think that will be the case.

Even though our clients were not hurt by the crash, we do not think that radical market disruptions, above or below the market's true intrinsic value, are good for the markets or investors. We will not rehash all of our concerns about hedge funds, since they were well covered in our August 2003 newsletter, but the issues have not changed.

The hedge fund bubble is not unlike other large, medium, and small bubbles. To extract a sufficient sliver of the large pools of liquid assets, Wall Street is responsible for creating, manufacturing, and promoting shapely, salable bubbles. Hedge funds are ideal Wall Street products. Investors are convinced that by paying a large incentive fee to hedge fund managers, they will run harder and make more money for investors (and for all the other service providers on the Street). Being less regulated, typically in the form of a limited partnership and unregistered with the Securities and Exchange Commission, even further enhances hedge funds' moneymaking potential.

Further, the hedge fund manager is free to go anywhere, long or short, anytime, and, by using leverage, with almost any amount of money. While there is no guarantee, this does make a very good story.

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THE ABCS OF INVESTING

We currently manage over \$500 million in client assets. Our minimum account size is \$1 million for a private client account. For investors who are unable to meet this minimum, we have a family of mutual funds that can accept much smaller initial investments.

While our CornerCap mutual funds represent only about 10% of our business, we are very proud of each of our no-load fund offerings and the performance they have delivered. In Jonathan Clements' February 16, 2005, article in *The Wall Street Journal* titled, "Choosing an Actively Managed Fund That Even a Passive Investor Could Love," the author listed nine selection criteria and

noted how few fund companies passed these screens. We were pleased to note that the CornerCap Group of Funds met each criterion listed.

Surprising as it may be, some investors invest in places other than CornerCap (see our lead article). For those investors, we expound on the ABCs for dubious investments, as follows:

(A) Annuities: We have analyzed numerous annuity products and investor situations in which these products might be appropriate. Seldom have we found a situation in which an annuity was cost justified. These

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THE WEALTH TRANSFER FUNDS (CONTINUED)

There are few real guarantees on Wall Street, but we know of at least two. One, whenever money is in motion, somebody on Wall Street is making a profit. And two, the client pays all costs associated with the management of money. With hedge funds, on balance, who is making money, who is paying the costs, and how material are these costs?

CornerCap's Hedge Fund

To quantify better these two guarantees as they relate to hedge funds, we show on the chart (see page 3) the net-of-fee investment returns for our Carolina Equity Fund (CEF), which is an equity limited partnership that the cofounders of CornerCap began managing over 25 years ago. We applied to these returns the typical fee structure for a well-regarded hedge fund, 2% per year plus 20% of any realized gains (realized after hitting the previous "high water mark" for the fund). In other words, for comparison purposes, we hypothetically converted our CEF into a hedge fund. Next, as a second comparison, we took our hedge fund results and applied 100% leverage. To improve investment returns, most hedge funds use leverage and frequently at much higher levels.

We have used a starting date of September 30, 1979, which is the date CornerCap's cofounders began managing the fund. On that date, the net asset value (NAV) of the fund was \$29.59. As of December 31, 2004, the NAV had grown to \$916, and that was after all costs of the fund: management fees, partnership administration, bank fees, transaction costs, accounting fees, intangible taxes, etc.

If CornerCap had set up the CEF with the fee structure of a hedge fund, the NAV of the fund as of its ending date would have been cut to \$441, a drop of over 50%. The fund created the same gross return, so where did all that money go? Of course, it would have gone to us, the managers of this unleveraged hedge fund.

While the additional compensation should be enough to make the hedge fund manager happy, the fund's clients would not be pleased since, as you will note from the chart, the fund would now be underperforming the benchmarks. But, there is a way for the hedge fund manager to make even more money and to outperform the indices to boot: Leverage!

As you will note from the chart, by leveraging, we are now able to "juice" up the returns, so that our ending NAV is \$1,284, well ahead of the benchmarks and of everything else. This looks like a no-brainer. By simply incorporating leverage, we are able to improve upon any positively sloping investment results significantly. Everybody wins. The client beats the benchmarks, the fund manager becomes really rich, and many other players on Wall Street pick up their piece of the action.

The One Legged Stool

What are we missing here? A top quality investment product needs to have all three legs of the investment stool. We know that we have had good returns, because we are viewing our

CEF results from the perspective of 25-year hindsight. Our net-of-fee returns were upwardly sloping, and we have leveraged them even higher. This leverage has created extraordinary returns that have made our equally extraordinary costs appear immaterial, so we must be okay with costs. What about our third leg, risks?

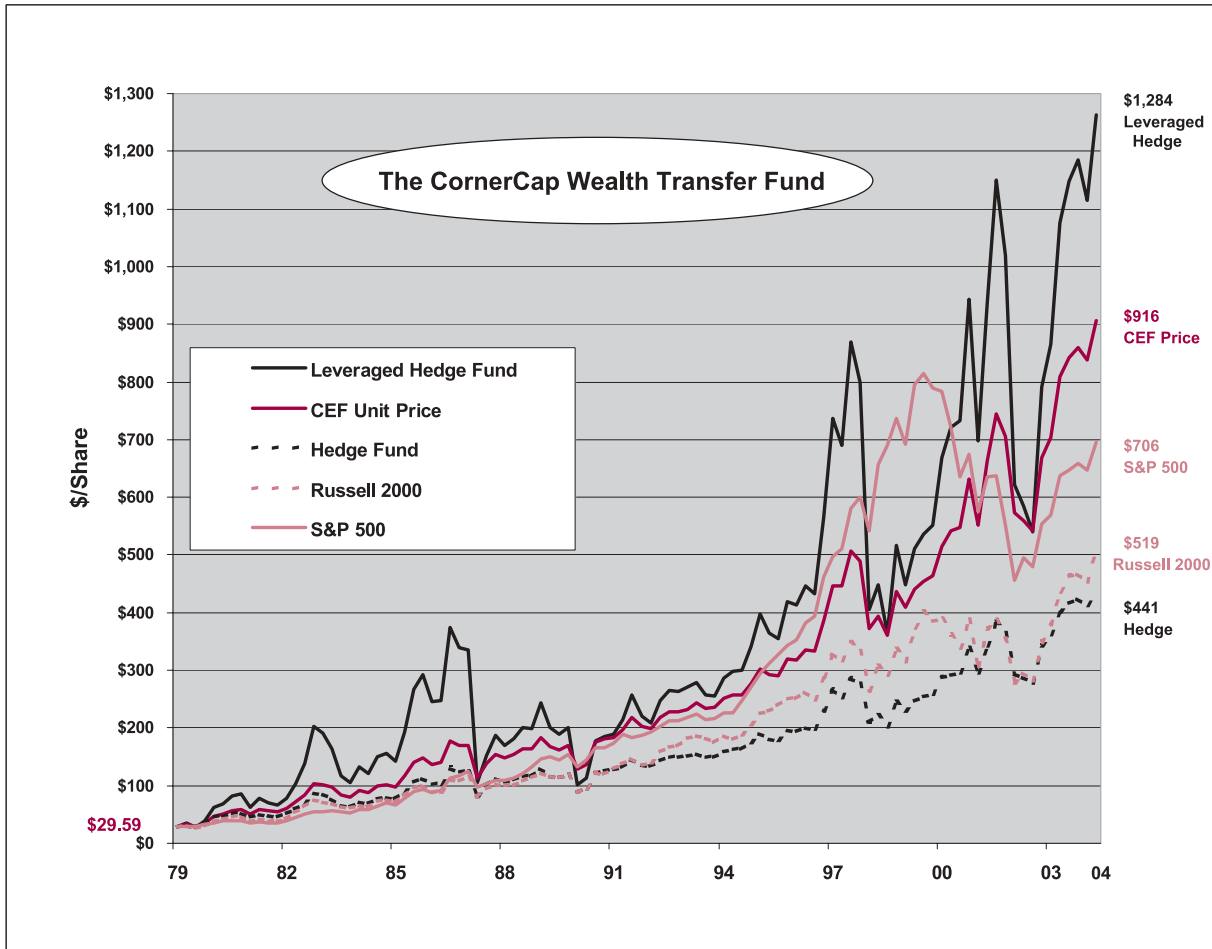
In referencing the chart, you will note the extreme volatility that we have created simply by applying 100% leverage to the portfolio. How do investors normally behave when faced with this degree of periodic downside volatility? Investors' behavior is actually highly predictable, and it is highly destructive insofar as ever realizing any potential long-term return.

From an economic perspective, the fund's returns are very long-term, which means that the investor must be there from beginning to end to realize the return. From an emotional perspective, the fund's risks are very short-term. However, our "leveraged hedge fund" experienced horrendous one-year declines of 57% in 1987 and 53% in March 2002, not to mention several other dramatic drops. You will not find a more patient and loyal group of investors as our CEF shareholders, but many of them would have fallen by the wayside during one of these downdrafts.

With highly volatile holdings such as our leveraged hedge fund, typical investors do not stay around to realize the potential long-term returns that might be available, and there is a high probability that their exit timing will result in negative returns. Investors tend to be attracted to a fund and buy in after returns have done well, and investors are disappointed and sell out when a fund is down. This behavior pattern is true for both institutional and individual investors.

A few years ago, Jack C. Bogle, founder of The Vanguard Group, cited a study of annual investment returns over a 17-year period. The S&P 500 returned 12.2%, and the average equity mutual fund underperformed this index by 2.9%, approximately the average total cost associated with running and selling the funds. The more disappointing part of the study was that the average equity mutual fund investor had only a 2.7% return over this period. Almost all of this lower return was attributable to poor timing by investors into and out of their equity funds. Extreme volatility amplifies the potential for an investor to make poor timing decisions. Our conclusion regarding leveraged hedge funds is that the extreme volatility, i.e., risk, will end up costing the investor more than the high operating costs.

While hedge fund hype has not reached the hysteria witnessed in the tech bubble, hedge fund investments possess some of the same wealth destroying characteristics. To be more precise, for the clients who invest in hedge funds, we see these investments as wealth destroying. As we have shown above, a major goal of hedge funds is the transfer of wealth, from Main Street to Wall Street. Since we choose not to have taxing authority over our clients, we will take a pass on the CornerCap leveraged hedge fund idea. ▲▲



Disclaimers: (a) Past performance is no guarantee of future results, and all investments are subject to risk of loss. (b) All investment results represent time-weighted, total returns and include reinvestment of interest and dividends. (c) The Carolina Equity Fund, L.P. is no longer available for new investors.

THE ABCs OF INVESTING (CONTINUED)

products almost always have hefty annual fees plus large surrender charges. These typically terrible products are sold based on being tax-deferred investments and having insurance to protect against a significant downside loss. These benefits are minimal and are far outweighed by the substantial fees paid to the selling broker.

(B) "B" Shares: Retail brokers must get paid for their services, and charging a load on mutual funds sold is one big way that brokers are compensated. A brokerage firm may sell either A or B shares. With either class of shares, the firm may charge 4% to 5% for the purchase of a load fund, and the selling broker will be paid some percentage of this amount, say 40%. If the broker sells A shares, the load or commission is all paid up front. If the broker sells B shares, the commission is called a back-end load, and it is only charged to the investor if he exits the fund before six years or so. However, even with B shares, the mutual fund company pays the broker up front. To make up for this up-front payment to the broker, the B-share mutual

funds tend to charge higher annual fees, and these mutual funds offer no reduced commissions or breakpoints for larger investments. Even though B shares appear more attractive and are usually an easier sell, our analyses suggest that investors buying load funds should simply purchase the A shares.

(C) Company Sponsored Broker Mutual Funds: The large wire-house brokerage firms all offer an array of in-house mutual funds, and it is in their best interest to sell these funds to the firms' clients. We have no problem with the bias to sell in-house products, but the funds are also biased to deliver average to poor performance relative to other mutual funds that are available. Morningstar®, a large mutual fund research and database service, ranks mutual funds from one (poor) to five (good) based on historic risk adjusted returns. The recent average ranks for U.S. equity mutual funds for three major brokers were, respectively, 2.9, 2.8 and 3.1, which were all below average. ▲

CORNERCAP HIGHLIGHTS

BEING ACCOUNTABLE

One of the firm's cofounders, Gene Hoots, has written a book called ***Being Accountable: Gene Hoots on Investing***. The book represents an accumulation of Gene's experiences over the past 30-plus years in investing, business, and with the people who make those things happen. If you are a client of CornerCap and would like a copy of this book, please give us a call.

CORNERCAP'S PRIVACY DISCLOSURE

In the course of client relationships, we gather and maintain personal, nonpublic information regarding our clients' financial circumstances and investment objectives. We are committed to maintaining the privacy and confidentiality of this client information. Accordingly, we have adopted a privacy policy in accordance with Securities and Exchange Commission and Federal Trade Commission privacy regulations that require us to determine and disclose how they treat nonpublic information to our clients and potential clients.

We collect nonpublic personal information about clients from the following sources: Information we receive from clients on applications and other forms; information about clients' transactions with us, our affiliates, or others; and information we may receive from a consumer-reporting agency.

We do not disclose any nonpublic personal information about our clients or former clients to anyone, except as permitted by law. We restrict access to nonpublic personal information about clients to those employees who need to know that information to provide products or services to clients. We maintain physical, electronic, and procedural safeguards that comply with federal standards to guard clients' nonpublic personal information.



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