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CornerCap® Investor

It's a Not So Wonderful Life

Who's Responsible for the Subprime Mortgage Mess?

Periodically, dramatic events happen in the market. Usually the event is real, perception causes the event to become dramatic, and we measure the magnitude of the drama in the marketplace. In July, a dramatic event began in the market.

The real event is the subprime mortgage mess. The mess was created by real people. Using the characters from the movie, *It's a Wonderful Life*, as our starting point, we will try to describe all of the modern-day characters who worked to get us into this mess.

Buyer Beware

The sad saga starts with us: we the people. The nice folks in Bedford Falls, USA, wanted more house than they could afford. They carelessly ratcheted up their lifestyle beyond their means. They assumed debt (mortgage) that was more complex and risky than they understood, and they assumed that the asset (house) would appreciate much faster than the cost of the debt.

Are we talking about greed here? Maybe, but we would rather reserve that term for Wall Street and not Main Street. We are talking about basic human nature. People can be enticed to buy something that they should not touch, be it a house down the street, swamp land in Florida, or a gold mine out West.

George Goes on Severance

Unfortunately, George Bailey is no longer employed by Building & Loan (B&L) to protect the nice folks in Bedford Falls. The B&L has been acquired, and George has been fired. George has been replaced by a staff of mortgage brokers who are paid incentive compensation based on the mortgage transactions closed. In fact, home buyers do not even have to go to the bank to get a mortgage. Approximately half of the subprime mortgages were originated with mortgage companies not affiliated with the banks, and therefore not subject to the bank regulators.

With George gone, Mr. Potter now has a staff of mortgage brokers transacting home loans for the townsfolk. Clearly, since Mr. Potter is a warped-minded, greedy, old man, he will ensure that the borrowers have sufficient credit and liquidity to pay back any loans that the bank might extend to them. Maybe not. Unlike the old B&L days, the new bank in Bedford Falls no longer holds the mortgage and collects the payments. After the mortgage broker collects his transaction fee, the mortgages are securitized and sold to some large financial institution on Wall Street that is responsible for collecting the loan repayments. The new

See It's a Not So Wonderful Life, Page 2

It's a Wonderful Life For Investing

Avoiding Crashes With Defensive Driving

The lead article discussed the cause and effect of the subprime mortgage debacle and its effect on the market. In this article, we will share our thoughts on the market, some historical perspective, and the risks and investment opportunities that we see going forward.

When John Bogle was recently asked about the substantial one-day sell-off in the market following the 20-year anniversary of Black Monday, he paraphrased Shakespeare's Macbeth, saying that "A day in the movements of the market is like *a tale told by an idiot, full of sound and fury, signifying nothing*." After over four years of steady increases in stocks, many investors view almost any downturn with shock and disappointment. Actually, as of this writing, the gyrating drops have been less than 10%, which should not be considered severe based on any historical perspective.

While there are clearly dislocations occurring in certain market sectors, the market does not appear overpriced at this time. The S&P 500 Index is trading at around an 18 multiple, which is in line with historic valuations when inflation is at this level. For the more speculative short-term investor, these periodic plunges do serve to keep the game more interesting, to weed out the marginal players, and to transfer more wealth from the clients to the service providers on Wall Street.

Lessons Learned

Moving beyond today's market mess, we believe that a worthwhile perspective can be learned from the meaningful market bubbles and crashes over the last few decades *(see the listing on page 2)*. What are the common threads that run through the above equity market events? What can we

See Wonderful Life for Investing, Page 3

mortgage brokers' incentive is short-term selling with no concern for long-term servicing.

The Village Goes Global

As you can see, there is a distancing taking place. The home buyer with the mortgage is moving farther and farther away from the ultimate investor. This distancing and insertion of multiple intermediaries makes the process of balancing risk and return throughout the chain much more difficult. It gets worse.

The creative investment bankers decided to repackage the mortgage-backed securities noted above into more sophisticated instruments, such as the much talked about CDOs (Collateralized Debt Obligations). In order to sell these overly complex securities to the yield-hungry investors, the investment bankers hired the bond rating agencies to evaluate and rate the "packaged" instruments. With a wink and a nod, the bankers suggested that the agencies be optimistic in their ratings, and they were. Go figure! This would be like CornerCap's paying an independent consultant to rate its firm for one of the consultant's clients.

The people in Bedford Falls knew and cared for each other. The incentives for doing the right thing emphasized character and reputation over making the most money. For better or worse, the village is going global. This change is being forced by technology, mobility, leverage, and other opportunistic developments. We cannot go back. We should not want to go back. Even with all the mess that has been created, many millions of families are in homes now that they otherwise could not have afforded, and our standard of living keeps improving.

"Welcome" Back Potter

Since we cannot go back, how should we move forward? Mr. Potter's greedy minions have replaced George Bailey. While we are not fans of overregulation, there need to be some federal regulations and controls. Like brokers in other industries, mortgage brokers need standards for the type of products that would be acceptable and unacceptable in a given situation.

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There also needs to be some consequence realized by the loan originators when a default that they created takes place. Also, the ultimate investors have an "investors beware" problem with the enterprising investment bankers and rating agencies. If the rating agencies are going to be relied upon by the investors, then the agencies need to be paid and penalized by the ultimate investors.

No Bells for This "Bubble"

While the subprime mortgage problem is real, we believe that the significance to the economy is being overdramatized. Near term, everyone in the above chain, from homeowner, to broker, to banker, to regulator, to rater, to investor, will all suffer. When the boundaries of prudent risks are exceeded, there must be a painful consequence for real learning to take place.

We do not believe that we can label this as a bubble or even a quasi-bubble. At CornerCap, we have historically fared well in the bubbles, avoiding any direct hits. Fortunately, we were not heavy investors in the subprime mortgage market, only holding a few mortgage-market equities. After a notable subprime roller-coaster ride during the last half of the year, both the market and CornerCap look forward to moving on from what may be more of a media event than a market event.

Clarence, the wingless angel, taught George Bailey many things, and we can also learn from Clarence. He showed George how many lives he had touched by all of the wonderful things that he had done in his life and what the world would have been like without him. We can see how many innocent homeowners' lives were painfully touched by the uncontrolled greed shown by the numerous players in the subprime mortgage money-making machine. When George finally saw the light, the bell rang, and Clarence got his wings. However, with the subprime market blip, the only bell we hear ringing is the same old one at the end of each trading session on the floor of the exchange.

The Meaningful Crashes

• Oil Bubble (1980). This commodity-based bubble proved to be a wonderful opportunity for our pre-CornerCap firm. Our Fundametrics® research moved us into the lower multiple energy stocks in time to catch the bubble's upside. In November 1980, with almost every advisor believing that oil was going to $100 a barrel (1980 prices), our research suggested otherwise, and we exited the sector. In December, the energy stocks began a gradual decade-long decline.

• Portfolio Insurance (1987). This one-day crash occurred 20 years ago, on October 19, 1987. During the original junk bond funded buyout boom, the academics had constructed a product (Portfolio Insurance) that gave the pension funds comfort with their increasingly bullish investments. Even though interest rates and equity valuations were rising during 1987, this "insurance" became a free pass for institutional investors to act recklessly. The academics who designed and marketed this product failed to model the effect accurately when all of the institutional investors tried to pass through the safety hatch at the same time. Following the 36% market free fall, it only took nine months for the market to fully recover. At the time, the current CEO of CornerCap was the senior investment officer at RJR Nabisco, and he was proud of the fact that he was making major equity purchases at the bot-

Wonderful Life for Investing, continued from page 1

learn from the past?

Overconfidence. Rather than a common thread, we would categorize treating overconfidence as more of a guaranteed component of any crash. We have always been amazed at the ease in which investors can acquire sufficient confidence in whatever is going on and place enormous bets. We have found this greed-based attribute relatively easy to spot, i.e., the oil and tech bubbles. The secret to spotting the next foolish market behavior is simply to (1) watch for a really large, well-formed herd that is moving rapidly in lock step and (2) confirm that every other investor out there believes you to be a total fool when you do not join him.

Experts' Models. The experts normalize historic data and create computer-based logic to model market behavior. These models may work 99.9% of the time in their back-testing labs. Some experts (oftentimes academics) are also good salesmen. As their flock of followers grows, their ".1%" probability of failure also grows, moving closer to a certainty than a minuscule probability. The most alluring pied pipers are most likely to lead investors off a dangerous cliff.

Debt Market. We have observed that the debt market is another common thread for market crashes. We had the rising interest rates in 1980 and 1987. We saw the collapse of the Long Term Capital Management Fund in 1989 that was leveraged in Treasury bonds, Russian bonds, and other debt securities. Most recently, we have seen the subprime mortgage market bring brief havoc to the equity market. When interest rates are rising, the perception of long-term inflation is also rising, and unbridled perceptions can move markets in mass.

Leverage. We believe that the overconfidence noted above causes investors to become lax in their standards for making loans and valuing stocks. This optimism seems to attract higher degrees of leverage, both financial leverage and concentration leverage. Over leveraging is the way to make a lot of money. An investor can also lose a lot of money, more money than is invested. When holders of huge concentrations of dollars all try to sell their similar holdings at the same time, they have to form a long line at the exit.

Correlation Risk. Based on daily trading activity, we believe that the hedge funds are the largest and most highly leveraged lump of money in the market. While the strategies employed by these hedge funds differ, some recent market behavior and research studies have indicated that many funds are effectively moving in and out of the same types of holdings. These *de facto* interconnections will cause major disruptions in the market, such as what we are now experiencing with the subprime connected securities.

Hedge Funds. All of the above warning signs are common to the hedge funds. A few predictions: More funds will continue to fail. The de-leveraging (i.e., selling) process will be powerful and will affect other hedge funds, resulting in a growing number of failures. These failures will by no means kill the business. The upside opportunity (with little downside) for the hedge-fund manager is too great.

CornerCap's Position

What has really changed over the last 30 years? Not as much as you might think. We still have long-term investors and short-term speculators. Buffett, Templeton, Bogle, Neff, Lynch, and other great thinkers about the market are saying the same things they have always said.

The next major drop in the market will be driven by some or all of the factors listed in our article. At CornerCap, we may or may not see the drop approaching, but if we do predict it (i.e., the two previous bubbles), we will not know the month or year when it will hit.

Long-term investing is so easy that we hate to make a public admission. You simply need a well-grounded philosophy and discipline that has been proven to perform well over time, a logical process for implementing the philosophy and measuring its disciplined implementation, and the ability to set the appropriate risk/return balance in the marketplace. This is what we have done, what we do now, and what we will continue to do.

Short-term investing is substantially more difficult. These "investors" ensure that Wall Street is highly compensated for funding and managing the games they are enticed to play, and Wall Street is huge and hungry. It is not unlike Vegas. There are some big winners, but the only guaranteed winner is the house account. The aggregation of all of the players is guaranteed to lose.

tom of the one-day crash. Not surprisingly, the CEO of RJR Nabisco did not share the same pride.

• Long Term Capital Management (1998). LTCM was an early hedge fund driven by a few highly regarded investment academics. At play, once again, was the overconfidence of the academics with what they considered as an almost "risk free" process. The inordinately leveraged bond-focused fund collapsed in the summer of 1998, threatening the liquidity of the entire market. Similar to 1987, the computer-based trading models helped drive the market down around 20% at the low point, but the Fed jumped in to strong-arm a rescue, and the market quickly recovered. With the growing influence of computer trading models, brief downturns of olden days were quickly turning into severe market routs.

• Tech Bubble (2000). The academics were important boosters for the late 1990s technology boom, internet extrapolations, and redefinition of the "new economy." Again, we saw the emergence of overconfident investors using leverage and overconcentration to take more risks than were appropriate. Similar to the Oil Bubble, our Fundametrics® research steered us away from technology, and we actually realized positive equity returns during the three-year market decline that followed the March 10, 2000, tech peak.

In This Issue:

It's a Not So Wonderful Life:
Who's Responsible for the Subprime Mortgage Mess?
page 1

It's a Wonderful Life For Investing:
Avoiding Crashes with Defensive Driving
page 1

The Meaningful Crashes
page 2

(From left) Tom Quinn, CornerCap CEO, takes a break to welcome Kevin McGonigle, Executive Vice President, and Cannon Carr, Executive Vice President, to CornerCap.

The Peachtree, Suite 1700
1355 Peachtree Street, NE
Atlanta, GA 30309
404-870-0700
www.cornercap.com

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