



CORNERCAP[®] INVESTOR

THE LOST DECADE?

With the S&P 500 Having Gone Nowhere in Nine Years, What's Next?

Some of us well remember the 1970s, when the stock market index was essentially flat for an entire decade. This extended stall in the equity market was caused by two disastrous fundamentals: (1) The OPEC oil cartel drove energy prices up astronomically, and (2) inflation was ratcheting up throughout the period.

Thirty years later, we appear to have circled back for a repeat of that disappointing phase. Several analyst commentaries, including a lead article in *The Wall Street Journal* in March, have labeled the 1999 to 2008 period the "Lost Decade." Over this nine-year period, the S&P 500 stock index was down 6.75% (-0.8% annually), lagging all other major asset classes, like commodities, gold, real estate, bonds, non-U.S. equities, and even the risk-free U.S. Treasury notes. Moreover, as with the 1970s, energy costs are once again skyrocketing, crowding out consumer purchases and contributing to fears of inflation. Investors are concerned that the Lost Decade may continue for some time into the future.

At CornerCap, our equity returns were well over the averages during the Lost Decade. Here, we share our thoughts on realizing reasonable returns over any extended period of time, for which a decade certainly qualifies. While the market will be unforgiving at times, we believe that a disciplined investment

process that recognizes the booms and busts of the short-term market swings is the key to avoiding the long-term pain. There is no magic. Beating the averages over time requires a consistent philosophy and strict adherence to a buy/sell discipline.

Putting Long Cycles in Perspective

Money, markets and emotions essentially force investors to stay focused on the daily skirmishes on Wall Street. Taking a broader view helps put things in perspective. The record unemployment and Great Depression of the 1930s followed



The S&P 500 offered no net return since 1999.

the unbridled optimism of the roaring 1920s. The inflationary 1970s followed the post World War II productivity boom in the U.S. that peaked in the 1960s. The market's correcting 2000s followed an absurdly speculative technology bubble of the 1990s and an unprecedented 18-year multiple expansion (1982 to 2000) of the price-to-earnings ratio for U.S. stocks, to a great degree caused by the growth of capitalization-weighted index funds.

These cycles are long and slow moving. In "recent" times, these cycles have lasted 30 to 40 years. You cannot pinpoint the days or months (and sometimes even the years) for these macro market turns. But interestingly, even with the length, height and depth of these cycles, investors seem unable even

See *The Lost Decade*, Page 2

WINNING THE LOSER'S GAME

Our Statistical Advantage

Winning the Loser's Game was the name of a book written by Charlie Ellis, an investment consultant whom we regard highly. The "loser's game" is professional investment management, where the professionals are so good and manage so much money that they become the market. That means the winners REALLY have to be good.

To win the game of professional investment management, Ellis says that

it requires a clear investment policy, reasonable investment objectives and a disciplined implementation.

Beat the Dealer was another book written about winning a game that is dominated by losers. Dr. Edward Thorp, a mathematician, wrote this book in 1962, showing how the game of blackjack could be won by using a few basic principles.

A few years later, Dr. Thorp connect-

ed his Las Vegas gambling knowledge to the games played on Wall Street, writing a few investment books and starting one of the early hedge funds, Princeton/Newport Partners. His funds were successful; he became a billionaire; and he continues to live happily ever after.

As an RJR senior executive once informed us, long-term investing is not gambling. True, they are not the same.

See *Winning the Loser's Game*, Page 3

The Lost Decade, continued from page 1

to keep their predictions in the ballpark. When we experience inordinately strong and extended markets like the 1920s, 1960s and 1990s, it is highly likely that returns will regress back to their long-term averages. In other words, the boom times steal future returns that were hoped for in the Lost Decades.

We will continue to have these long cycles of greed and fear. As we have oftentimes said, we believe that trying to time the short-term cycles of the market will probably lower investment returns. However, long cycles are different. They are easier to spot; the exact timing is not necessary; and the cost of implementation (taxes and transaction costs) is modest due to the infrequency. Continuing on with our cycle logic, our assumption is that the Lost Decades are adjusting for prior excesses and then storing up future returns for the next boom time.

Managing through Long Cycles

In December 1980, the founders of CornerCap sold all of our energy-related holdings. This marked the approximate end of a 10-year energy run up and the beginning of a 10-year energy price decline. This occasion was also near the end of another Lost Decade, the 1970s. We did not exit the market; we just exited the sector of the market where all of the “experts” agreed that prices would continue to rise indefinitely.

In March 2000, CornerCap was completely out of technology stocks and was significantly underweighted in the mega-cap stocks. While most investors suffered through the 2000 and 2001 major market declines, our portfolios were up significantly. This was near the beginning of a new Lost Decade.

At CornerCap, our discipline helped ensure that we did not experience the Lost Decade. Again, we just exited one sector of the market and underweighted the larger capitalization stocks. The eventual market declines were concentrated in these two areas of the market.

The Coming Decade

Where are we now? How should our portfolios be positioned? Successful investing requires simply keeping the prob-

abilities in your favor. Fear appears to be rampant now, with many investors selling their stock holdings. Probabilistically, broad selling now makes absolutely no sense. In the relative flows of the long market cycles, the end of a Lost Decade appears to be a time when the market is more down than up. We always recommend buying low and selling high.

What if oil prices go to \$200 a barrel? They could. We heard the same cry in 1980. There was no logical counter argument to the experts' qualitative assessment. The reality was simply that the pendulum had come a long, long way. The pendulum was bumping into a mass of people who were tired of getting hurt, and there were lots of smart people eagerly searching for ways to eliminate that pain (and get paid for doing so). There are solutions to the energy problem, and as prices rise, the search for those solutions will intensify.

What if inflation goes to 10% or more? It could. It happened in the late 1970s and early 1980s. On the encouraging front, just like in the last Lost Decade (1970s), some expectation of inflation has already been priced into the equity market. Also, our nation's financial controls are much better today than they were in previous downturns of the long cycles. And, even as wild as they appear, we believe that today's markets are better behaved than in prior periods. Our interpretation of these extreme short-term market movements is that security information, market data and investor emotions are being priced into the value of the equity securities more quickly today. This immediate liquidity and pricing creates more efficient markets and less severe peaks and valleys for the long cycles.

What about all of the other economic problems that we know are out there, such as the credit crunch, a continued housing bust, the decline in the dollar, the expectation of higher taxes, an extended recession, etc.? We believe that the most current information on the always present myriad of economic problems has already been priced into the market. As history has shown us, the future market problems (and opportunities) will come from events not currently showing on anyone's radar screen.

The Odds-On Favorite

We cannot accurately forecast the macro economic variables such as those noted above. We cannot time the dramatic near-term swings that must be part of the daily routine in the life of the asset class that offers the highest long-term return opportunity, with immediate liquidity and pricing. What can we do?

We can keep the probabilities in our favor. We can realistically observe the behavior of other investors. We can objectively quantify when their behavior overpowers the facts. In the long cycles, we can take advantage of those infrequent but really extreme investor obsessions. In the short cycles, we can continually rebalance our portfolios. We can rebalance asset classes to their target weightings, sectors and industries to their current fundamentals, and individual holdings to their planned equal weightings.

Simply stated, if we pay attention to the probabilities rather than the pundits, we may lose a few small hands but we should ultimately win the game. Winning means avoiding the extremes that cause a Lost Decade to be lost and being there for those winning decades. ▲

CLIENT VISIT TO CORNERCAP



CornerCap recently enjoyed a visit from our most senior client, George Roberts from Asheville, N.C., who is 97 years old. Mr. Roberts shared his wit and storytelling when Doug Dougherty (right) and Tom Quinn (left) took him to meet the CornerCap staff.

Winning the Loser's Game, continued from page 1

However, CornerCap and some other noted investors have found some of the principles of prudent professional gambling to be value adding. The most noted investor who closely follows Thorp's gambling principles is Bill Gross. At RJR, we were the second institution to hire PIMCO, the firm that Bill grew to be the largest fixed-income investor in the world. The two key investment principles that Gross and Thorp profess are:

1. **STATISTICAL ADVANTAGE.** Develop a statistical process that will result in a quantifiable advantage over others who are in the game.
2. **AVOID OVER-BETTING.** Never bet (i.e., invest) more than is justified by your quantifiable advantage.

Statistical Advantage

Thorp and Gross used card counting to create a slight statistical advantage in playing blackjack. Similarly with their investment practices, they created disciplined processes that provided them with a modest statistical advantage over other investors.

At CornerCap, our research shows a statistical advantage with our Fundametrics® equity research system.

With Fundametrics®, each week we compute numerous valuation models for a large database of stocks. We also compute a composite valuation for each stock by assembling a "portfolio of models," sometimes called a multi-factor model.

Using this composite valuation, each week we group our universe of stocks into buys, holds and sells, and we measure the actual returns realized by each group or ranking. Based on over a quarter century of weekly returns, we have seen that the Fundametrics® process has given us a significant, quantifiable advantage.

Avoid Over-Betting

This principle should be relatively simple compared to the one above, but that does not seem to be the case for many investors.

With gambling, you simply make numerous small wagers, avoiding what is called gambler's ruin. The gambler must be there to reap the benefits of their statistical advantage. Never

become emotionally involved or overconfident and end up betting the ranch. Like investing, it only requires a process and the discipline to stay with the process.



Unlike Blackjack, long-term investing is not a gamble, although to win at both, you must develop a statistical advantage and avoid over-betting.

At CornerCap, we control over-betting by having a specific limit on the amount of a client portfolio that can be invested in any one security.

We also have a limit on the amount that can be invested in a sector or asset class. We broadly diversify our holdings. We do not deviate from this process. We have created a demonstrable statistical advantage, whereby we position ourselves to capture that advantage and win the game by simply having enough at bats. We may not be the home run leader, but our primary goal is only to get enough singles to "win."

Losing the Loser's Game

We realize that the process we follow is somewhat boring, lacking much pizzazz. Today's pizzazz is probably best found in the hedge fund game. As a measurement of traditional investments, the annual flows added to U.S. stock mutual funds has gone from the \$260 billion peak in 2000 to an outflow of \$46 billion last year.

At the same time, the hedge funds have ballooned to \$2 trillion under management. As investors languished through the Lost Decade, we believe that they have been looking for returns in all the wrong places.

With regard to the principles discussed above, hedge funds are seeking and selling the statistical advantage that

they believe they are able to capture. Like CornerCap, they have an idea that they believe creates an advantage over other investors. Unlike CornerCap and running counter to the above principles, they are significantly over-betting, and their need to do so is growing.

The hedge fund business has gone from \$100 billion to \$2 trillion in 15 years. The funds are operating in an investment universe of niche ideas.

While the number of funds and assets chasing those ideas has skyrocketed, the number of niche ideas has not grown that much. As each new fund and dollar comes into the market, the excess returns from the originally unique ideas are being margined away.

As a result, the only way to increase the hedge fund's return is to continue to increase the leverage (borrowings) of the funds. Over leveraging equates to over-betting, and this equates to a growing number of hedge fund disasters (gambler's ruin).

Let the Games Begin

Professional investing is not gambling and does not have to be a loser's game. It requires some brainpower, an understanding of numbers and probabilities, a time commitment and a disciplined process. We appreciate those investors on the other side of the table who lack these attributes but still want to play the game. They provide a means for increasing our statistical advantage. ▲

VISIT OUR NEW WEBSITE!

Go to www.cornercap.com
to see our new look!



In This Issue:

The Lost Decade?

*With the S&P500 Having
Gone Nowhere in Nine Years,
What's Next?*

page 1

Winning the Loser's Game

Our Statistical Advantage

page 1

Client Visit to CornerCap

page 2

Take a Look at Our New Website!

page 3



(From left) J.C. Long, Georgia Shakespeare Actor; Anno Hardage, CornerCap's Director of Client Service; Jim Carr, President of CornerCap; Richard Garner, Georgia Shakespeare's Co-founder; and Debby Kelly, Chairperson of Georgia Shakespeare's Board of Trustees review some of the new costumes before opening night.



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

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

J. Cannon Carr, Jr., *Executive Vice President*
Kevin M. McGonigle, *Executive Vice President*

Portfolio Management
Richard T. Bean, *CFA, Vice President*
Douglas M. Dougherty, *CFA, Vice President*
Anno M. Hardage, *Director of Client Service*
Jeffrey P. Moeller, *CFA*

PRESORT
FIRST CLASS
U.S. POSTAGE
PAID
WOODSTOCK, GA
PERMIT NO. 428