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CornerCap® Investor

U.S. Treasury Bonds: The Third Bubble

What happens when the era of "cheap debt" ends?

More and more people are calling U.S. Treasury bonds "the third bubble" on the heels of their rally. We don't disagree. Whereas the first two bubbles—the Internet craze and housing boom—were driven by extreme optimism, this bubble is capped by fear and the quest for safety.

But it has been building for 20 years, in the form of increasingly cheap debt. It arguably helped fuel the first two bubbles. As it unwinds, it will have wide implications for everything we do, from consumption, to investing, to economic and social policy.

Cheap Debt and What It Can Do for Us

Forget the current debate about whether rates will rise or fall in the coming year. Their near-term direction is certainly important, but impossible to predict.

Instead, consider that yields on Treasury securities have fallen dramatically since 1980. At that time, yields on 10-year Treasury bonds were over 15%, after a period of runaway inflation (*See Exhibit 1*). By 2000, they were around 5%, a level unseen since the 1960s. And yields have only fallen further since then. Think what it felt like to take out a mortgage or use a credit card at rates like those of 20-30 years ago!

With the cost of debt at its cheapest in 50 years, we have essentially been able to "have our cake and eat it too." This is not meant to be a judgmental comment. As long as there's cheap debt and lenders willing to finance consumption, it works.

Accordingly, inexpensive borrowing is driving high con-

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Was the Lost Decade Lost?

A look back at the Internet bubble and its ensuing impact on performance

With the 10-year anniversary of the Internet bubble, and our accompanying article on the likely Third Bubble, we thought it constructive to recap our investment decisions during this tumultuous decade. The exercise points out the absolute necessity of having an investment discipline and sticking to it, especially during the best and worst times.

The Dark Days Ten Years Ago

March 10th 2000, marked the peak of the Internet bubble. We held few if any tech stocks and in fact had avoided or exited most tech holdings many quarters prior due to absurd valuations. That day also marked our worst relative-to-market investment returns since entering the investment business in the late 1970s. We had experienced five straight quarters of severe underperformance. And we seemed destined for a sixth disaster quarter. In the first 10 weeks of 2000, the NASDAQ increased 24% and our small cap strategy was essentially flat.

As clearly documented in our quarterly commentaries and newsletters for that time, we never doubted that we were right in our investment decisions. However, we did wonder whether we would be proven right soon enough to save CornerCap. We had already lost 10% of our client base as they became more and more disenchanted with us, leaving us to go to advisors or brokers who were saying only what people wanted to hear.

Fortunately, we did not have to wait any longer to find out just how loyal the others might be. For the next ten years, our decisions made during the tech bubble sowed the seeds for a period of strong relative outperformance (*See Exhibit 3*), as depicted by the CornerCap Small Cap Composite. In hindsight, it is obvious that this did not HAVE to be the Lost Decade.

To show the extremity of the market at the time, let's assume that someone had been invested in the tech-heavy NASDAQ from January 1 until March 10, 2000, and then had switched to our small cap strategy. Their return for the years 2000 to 2010 would have been 198%. But assuming they switched the other way, from our small cap strategy to the NASDAQ, their return would have been -50%. We knew people who did this. One client told us 13 months after the peak that he had lost it all and would be working for years to replenish his nest egg.

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Exhibit 1: Yield on 10-Year T-Bill (Monthly)

Source: U.S. Federal Reserve

sumption, which in turn raises incomes and standards of living. It has helped drive the savings rate to historic lows. It is giving governments broad policy tools to tackle a range of social and economic challenges. In many respects, it has refined the current party lines in our own political system.

Why Is Debt So Cheap?

The role of the U.S. Dollar in the global financial system is a key reason for all this cheap debt. The world simply needs the U.S. Dollar ("USD"), for its ubiquity in trade, stability in crisis, and flexibility/liquidity in economic policy. This is why the USD has served as the world's dominant currency since World War II.

Foreign governments in China, Japan and Europe, for example, seek holdings in USD (typically acquired as Treasury securities) to support global economic policies and currency management.

Foreign governments currently own $3.8 trillion of Treasury securities, up about 19% from a year ago. (For more on the USD, see our Fall 2009 newsletter on our website at www.cornercap.com.)

With such strong international demand, the U.S. government has been able to run sustained deficits with little penalty. These deficits, in place for most of the past 40 years (*See Exhibit 2*) allowed us to spend broadly on global military intervention, expand entitlements, and pursue other agendas, while keeping taxes generally low.

We have had a virtuous circle of low-cost funding. It enabled the historic government intervention of the past 18 months, which is why we say that government intervention did not create the Treasury bubble, but it has amplified it through higher debt and deficits.

Why Will Debt Become More Expensive?

Debt will inevitably become more expensive in the next decade because risk has increased. Consider that consumer spending accounts for two-thirds of GDP growth in the U.S., and that consumers carry about 70% more household debt than they did 25 years ago. Mortgages plus credit card debt are now 130% of disposable income.

With the U.S. deficit at record levels, the U.S. government must continue to tap international lenders simply to fund the deficit. All this challenges GDP growth, which in circular fashion is needed to close deficits.

This is not to say that the outlook is "gloom and doom" or that higher cost of debt will emerge quickly. Nevertheless, at some point, it is highly probable that lenders will seek a higher rate of return to compensate for their incrementally greater risk. This is a natural balance.

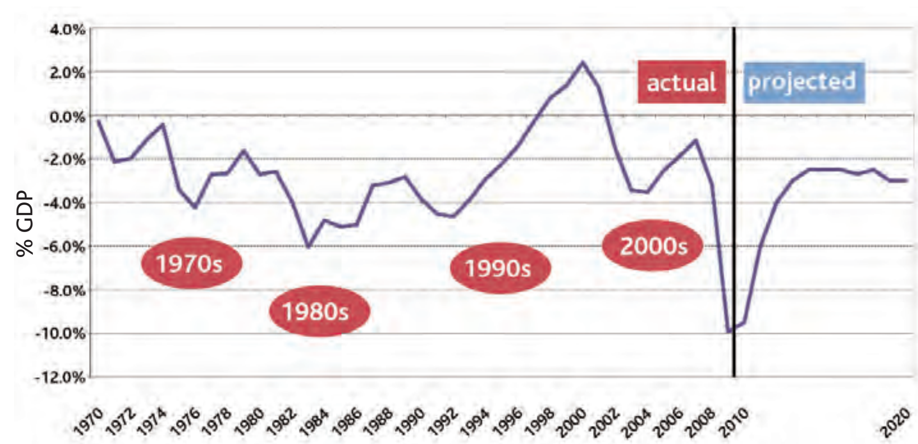
The Bottom Line

Our message is that: 1) unique circumstances fueled an era of historically cheap funding; 2) the next ten years will likely be different than the past 20, where debt is incrementally more expensive; and 3) higher borrowing costs will challenge our ingrained assumptions about standards of living and policy choices.

As we have discussed, the unwinding of cheap debt will also present new opportunities and risks for investors. We can't predict when the era of relatively cheap debt ends, but we must plan accordingly. We continue to assume deflation prevails for the near-term but inflation is the more likely scenario in five to seven years.

For further discussion there, see our quarterly commentaries at www.cornercap.com.

Exhibit 2: U.S. Budget Deficit/Surplus Since 1970



Source: Congressional Budget Office

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Exhibit 3: Market Values and Total Returns over the Past Decade

Total Returns From 3/10/2000

	3/9/2008 Nine Years	3/10/2010 Ten Years	10 Years Annualized
Common Benchmarks			
S&P 500	-41.5%	0.2%	0.0%
NASDAQ	-73.1%	-49.8%	-6.7%
Russell 2000	-33.0%	33.3%	2.9%
CornerCap Small Cap Strategy			
Small Cap Composite	12.5%	140.1%	9.2%

Source: CIC, Bloomberg
For regulatory disclosures about returns, see the footnote at the end of this article.

Technology Winner – Be a Renter

A few months after the peak and tech stocks had slid, friends would ask, "Technology is the best performer over any 10 years, isn't it? The tech stocks will come back, won't they?" Our answer was, "No, sadly technology was the best performer over the LAST decade, not over every decade." In fact, history shows that when an industry leads the way for a decade and collapses, it almost never leads the recovery.

What transpired? In March 2000, the 10 largest tech stocks were 19% of the S&P 500's market cap. At the time, we began tracking 13 well-known technology stocks (*See Exhibit 4*).

There have been two winners and eleven losers since March 10, 2000. An equal weighted portfolio would have returned -53%, a bit worse than the NASDAQ. The big winner was Amazon which returned 96% and eBay showed a small profit. The return for the other eleven stocks has been -72%. So just to recover the lost decade, the portfolio must double and the eleven losers must increase 252%.

We wrote an article shortly before the tech bubble collapse saying how much we loved technology but just did not want to pay too much for it; that we'd rather be its customer than its owner. This love has not been misplaced. Tech companies have benefited their customers but not their investors. Technology was the most profitable sector in the S&P 500 in 2009. Since the beginning of 2000, tech companies have generated $608 billion in cumulative profits and have piled up $349 billion in cash, 35% of all nonfinancial corporations. As predicted, the Internet has been hugely successful. But the price ten years ago was way too much for the results delivered.[1]

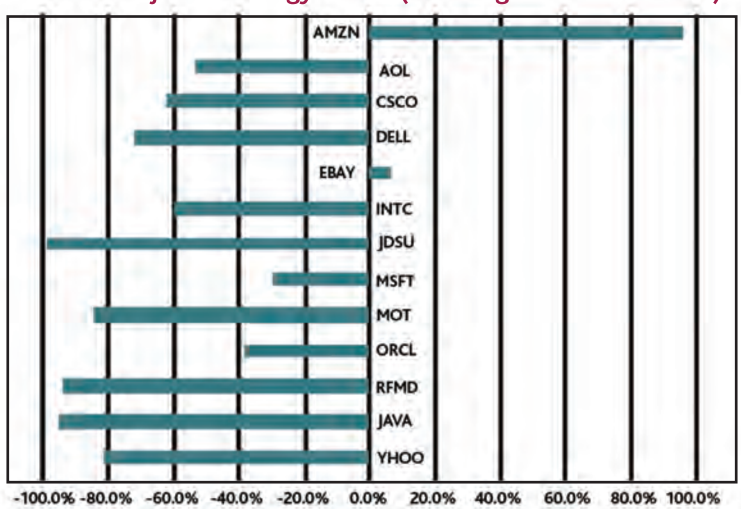
What Have We Learned?

There are times in this business when we will do great, and there are times that will seem like a disaster. What matters is how you conduct yourself in both times. For CornerCap and our clients, we have been very pleased with our returns over the last decade. Even though bracketed by bear markets on both ends, the Lost Decade was not lost at all. However, we would welcome a few less challenges in the years to come.

At this important anniversary, we thank you all for the support you have given us in the good times and the bad.

[1] *"Tech Companies Won, Investors Lost", by Jason Zweig,* The Wall Street Journal, *March 10, 2010, p. C1.*

Exhibit 4: Major Technology Stocks (% Change Since 3/10/2000)



	Ten-year Return
Total Portfolio	-52.9%
Portfolio (Excl AMZN and EBAY)	-71.7%

Ten Year Change 3/10/2000-3/10/2010

Source: CIC, Bloomberg

CornerCap Performance

CornerCap Investment Counsel, Inc. (the "Company") is an equity investment management firm whose objectives include Small-Capitalization, Small/Mid-Capitalization, Mid-Capitalization, Large/Mid-Capitalization Separate, Commingled, and "WRAP" accounts. CornerCap specializes in investment approaches that either focus purely on quantitative factors or include a combination of quantitative factors and qualitative analysis.
Past performance is no guarantee of future results, and all investments are subject to risk of loss. Performance is presented in U.S. dollars.
The following table shows composite returns for the Small Cap strategy offered by CornerCap. These returns do not represent the results of any single client. For a complete list and descriptions of CornerCap's composites, please send a request to info@cornercap.com.

Periodic Returns	Qtr.	1-Yr.	3-Yr.	5-Yr.	10-Yr.
Composite Gross	7.78%	82.08%	-2.07%	2.26%	9.29%
Composite Net	7.50%	79.83%	-3.36%	0.96%	7.94%
vs. Benchmark					
Russell 2000 Index*	8.85%	62.76%	-3.99%	3.36%	3.68%

*The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. CornerCap Investment Counsel, Inc., claims compliance with Global Investment Performance Standards (GIPS®)

In This Issue:

CornerCap Investment Counsel Launches "Virtual Safe" Deposit Boxes

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CornerCap Investment Counsel, Inc. has rolled out a virtual vault site called CornerCap® Investment Counsel's Secure Client Website. This website is robust, easy to use, and most importantly, a secure web-based system for managing client communications and reporting.

This simple password-protected site is designed to electronically publish CornerCap statements in a secure environment.

If your are interested in accessing your client vault account, please contact John Hackney or Jennifer Record at 404.870.0700 and advise them of your log-in name preference. They will assign a temporary password and access instructions at that time.

CORNERCAP
INVESTMENT COUNSEL

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

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