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CornerCap® Investor

The Irresistible Melody of the Pied Piper

The market crash exposed weakness in the long-heralded "Endowment Model." What did we learn about it? And how do we think about structuring portfolios for uncertain times?

The legend of the Pied Piper of Hamelin relates the story of a man hired by a rat-infested village to remove the unwanted rodents. When the townsmen refused to pay the piper upon completion, he returned to Hamelin and led the town's children away with his musical pipe.

Just as the children of the village fell prey to the hypnotic music of the Pied Piper and were lured to their demise, many investors have also been led astray by a financial pied piper, whose siren song of complex asset allocation strategies was alluring but easily misunderstood.

Asset Allocation on Steroids

At its heart, asset allocation theory is built upon the concept of investing in asset classes that do not move in the same direction at the same time, or by the same degree.

Diversifying into asset classes with such low or negative correlations is logical and supported by the work of mathematician Harry Markowitz, winner of the 1990 Nobel Prize in economics for his ground breaking theories in portfolio management.

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David Swensen, upon taking the helm of Yale University's endowment in 1985, expanded upon the basics by arguing that the low or negative correlations of riskier assets as a group will offset the volatility of each asset class individually.

In other words, by including uncorrelated risky assets, you get higher portfolio returns than a traditional stock-and-bond portfolio, at a similar level of risk.

Gradually, Swensen's approach transformed the traditional "60-40" percent allocation of traditional stock and bond portfolios to include a wide array of asset classes, including private equity, hedge funds, venture capital, timberland, and infrastructure projects. Exhibit 1 *(see page 2)* shows a sample allocation for large endowments like that of Yale, where as much as half

In Summary

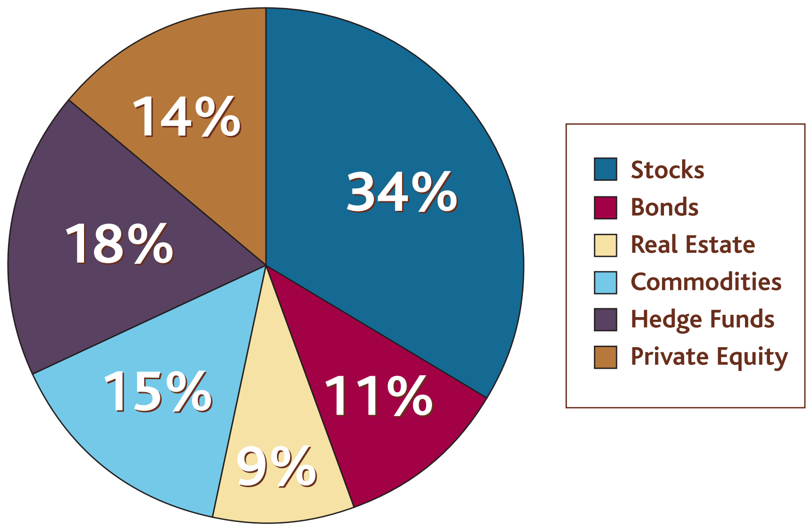
Between the early 1990s and October 2008, the endowment model championed by pioneer David Swensen at Yale created an aura of invincibility. Returns were superior with apparently lower risk. Hearing this irresistible melody, many investors followed the tune (including heavy allocations to hedge funds and private equity), only to be caught tone-deaf during the ensuing but inevitable market crash.

The lesson? Obvious in hindsight is that volatility is part of the musical score and can't be completely "diversified away." Even the large university endowments couldn't escape, although they have the resources and capacity to adjust. More subtly, however, is that most investors and institutions should not blindly follow the strategies of endowments like Yale or Princeton. In some respects they have advantages not open to average investors. Yet they also suffered from dangerous assumptions about risk and liquidity.

Recognizing that you must always pay the piper (risk) for an expected return, we believe the market downturn underscores that proper investment strategies must incorporate how different investments (stocks, bonds, T-bills, commodities, real estate, etc.) perform through different economic cycles, all while balancing individual investor liquidity needs and risk tolerance. As we have long said, investments must be simple and transparent, easy to rebalance, and avoid imbedded fees. There's no free lunch. This is how we strive to construct our portfolios.

See The Irresistible Melody, Page 2

Exhibit 1: Common Large Endowment Asset Allocation Strategy



Source: Advisor Perspectives (2008)

the portfolio may consist of such "alternative assets."

Swensen's approach enjoyed tremendous success for a number of years. By the spring of 2008, the endowment had averaged 16% annually for 20 years, which was well ahead of most other endowments and pension funds.

Same Principle—Different School

Swensen's long record of success encouraged others to follow the music. Particularly after 2002, smaller university endowments, pension funds and even individual investors sought allocations with greater percentages of risky assets on the promise that low return correlations would provide above-average returns with downside protection.

Everyone knows how the story ends. The piper extracted his vengeance. During the downturn, the 10 largest U.S. endowment funds lost an estimated $36 billion. The average college endowment was down a reported -19% for the fiscal year ending June 30, 2009, with Yale and Harvard down -25% and -27%, respectively.

Since endowments had begun covering an increasing amount of school operating budgets (as much as 50%), universities were forced to cut staff, shelve projects and sell securities at distressed levels. Individual investors had to return to work or delay retirement. Many nest eggs were destroyed.

Learning From the Endowment Experience

While we do not believe the endowment experience refutes basic asset allocation strategy, we do find important lessons for the average investor.

First, the "complex allocation" model, consisting of uncorrelated but illiquid investments, was built during an era when cash was plentiful (low interest rates, easy credit, strong returns). Moreover, plentiful cash arguably helped sustain the long period of outsized returns. Ample cash and sustained returns gradually lulled practitioners into a false sense of risk-reward.

Second, with this misalignment of risk-reward, endowment managers assumed they could rely more heavily on investment gains to support higher spending plans for their universities. Their initial success confirmed this commitment. The crash clearly uncovered the pain of illiquidity and the erroneous assumptions about portfolio performance in economic extremes.

Third, the strong initial results and complexity also hid the fact that only the best private equity managers and hedge funds produce attractive returns. Most endowments and investors do not have access to this group, as their funds are closed before the mainstream can consider them.

In contrast, the average returns from this asset class often do not match the average returns from typical stocks and bonds once the heavy imbedded fees are subtracted. With mediocre results on average, the average endowment and investor cannot produce the elite endowments' returns in alternative asset classes.

Fourth, and perhaps most fundamentally, the endowment experience highlighted that correlations between asset classes are extremely unpredictable over shorter time periods. Correlations change with the economic cycles and pricing environment, which cannot be "timed." Predicting the swings is impossible, but they must be considered when constructing portfolios, particularly with increased complexity and illiquidity.

Adding to this potential short-term extremism is the influence of investors' appetite for risk. Historical correlations among risky assets tend to hold in periods where investor demand for risk is high. However, when investors' demand for risk declines, the historical correlation patterns tend to break down. In times of extreme risk aversion, like what we experienced in late 2008 and early 2009, risky assets tend to move in the same direction, which further complicates predicting theoretical correlations.

Back to Basics

As many investors found out the hard way, blindly following complex asset allocation models or pursuing portfolio diversification for the sake of diversification alone is dangerous. It can result in increased cost and diminished long-term returns. Moreover, as short-termism grabs hold in a

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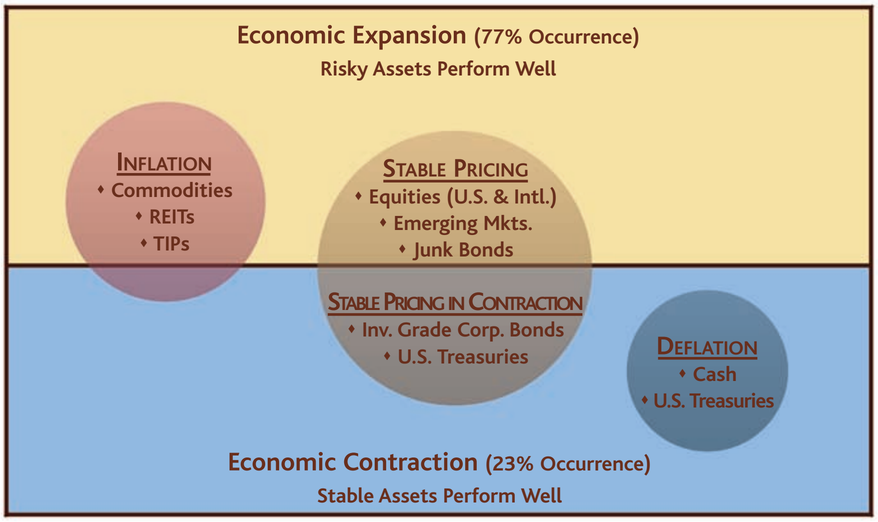
Exhibit 2: Our Allocation Framework



Source: CornerCap Investment Counsel

panic, a portfolio may even unexpectedly lose theoretical diversification benefits, potentially eliciting destructive behavior (irrational selling or decisions).

To build portfolios to weather economic uncertainties, we believe asset allocation strategies must be transparent and simple. At the same time, they must recognize that asset classes can behave differently depending on the underlying economic environment.

When contracting, the economy typically negatively affects most equity investments (domestic and international stocks) as well as most commodities, real estate and lower quality bonds. Many endowment portfolios that were believed to be well diversified were actually highly leveraged to a stable growing economy with little exposure to the asset classes that historically do well in a contracting or deflationary environment.

This is why CornerCap's asset allocation strategy begins with a framework that strives to reflect how asset classes perform in various economic environments *(See Exhibit 2)*. Allocations to specific asset classes are selected to diversify the portfolio for the different economic cycles and pricing environments.

The specific allocation strategy for each client must be customized to the client's individual situation and goals, and should be diversified across the various economic regimes with consideration to the client's tolerance for risk, volatility, and liquidity.

The goal is to maximize the expected return for the level of acceptable risk. The asset allocation targets will only shift as the investor's circumstances change, and not in response to economic forecasts and market predictions.

The key is correctly identifying and setting the "acceptable risk" for the owner of the assets. This is determined by the client having the financial means or ability to accept risk and the emotional willingness to accept risk.

The ability to accept short-term portfolio volatility is based on the client's current financial circumstances and goals. However, the client's emotional *willingness* to accept risk might not match his *ability* to accept risk. The danger in setting an asset allocation strategy based solely on the ability to accept risk is that the client, under the emotional stress of a market downturn, will change the long-term investment plan at the wrong time and in the wrong direction.

In Conclusion

Recognizing that you must always pay the piper (risk) for an expected return, we believe the market downturn underscores that proper investment strategies must incorporate how different investments (stocks, bonds, T-bills, commodities, real estate, etc.) perform through different economic cycles, all while balancing individual investor liquidity needs and risk tolerance.

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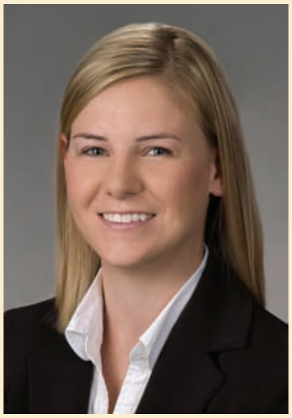
In This Issue:

For the Record ...



Those of you who have spoken with Jennifer E. Record, Manager of Client Service Administration, since she joined CornerCap in September 2009, already know how fortunate we are to have her. Matching the technical skills with the people skills needed for this position is not an easy task. For the record, Jennifer fits the bill.

Before joining CornerCap, Jennifer served as a relationship specialist with Charles Schwab, assisting investment advisory firms in the Atlanta region. Prior to Schwab, she worked in wealth management for a firm based out of Chicago with a 100-plus year history. Jennifer holds several FINRA licenses including Series 66, 7 and 9/10.

As a graduate of the University of Florida , BBA , we are all engaged in a full scale campaign to teach her about real college football. All kidding aside, we are pleased to welcome Jennifer to our team!

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