

## **What Do You Mean? We Love Technology!**

A client and friend recently said in passing that she realized how much we did not like technology companies. She is probably not alone with this belief. But it is not true. The fact is that we love technology, and we love the companies that create these new productivity vehicles for us to use. In fact, our firm has made a commitment to be a leader in the use of technology, and these development costs have grown to be a major portion of our budget. We implemented our new Portfolio Manager Optimizer System this spring, and we will implement our new Roxy Trading System this summer. Both systems are Internet based and internally developed. We also plan to complete our new Web site this summer.

### **The State of Value**

Of course, this client was talking about technology as an-investor-in versus a-user-of. In that context, here again, we do not have a problem with technology (or any other sector). We work hard to be unbiased and unemotional with our investments, focusing only on the fundamentals of the company and the investment discipline that will add the most value. For over 20 years, we have used an investment discipline that emphasizes “value” principles. We will periodically find a good technology stock that meets our value criteria, but technology will not be a large weighting in any true value portfolio.

Why did we choose this more value-oriented approach? Up until the last two years, value investing tended to generate the highest returns, and, because of the lower prices paid for a dollar of company cash flow, it also tended to be at lower risk. We have always managed serious long-term institutional and individual retirement assets. Value investing is appropriate for these investments, and it has worked very well over time. The value approach was out of favor until March 10, 2000, when it appeared to turn on a dime. The probabilities are that value investing will continue this outperformance for the next few years, but, as always, no one knows for certain.

### **The State of Speculation**

Investors who speculate and do it wisely should be paid more than investors who do not speculate. If these investors are willing to risk the permanent loss of their capital, they should be rewarded. Startups and companies with no proven business model or proven management are speculative. Companies with no earnings are usually speculative. Speculative investors fund creativity, innovation, and aspiring entrepreneurs. When they work, they create wealth for the investors and greater productivity and other benefits for our businesses and for society at large. When they fail, many investors lose their capital.

Since March 10, 2000, many speculative investors have lost a great deal of capital. As described in a recent *Wall Street Journal* article, “Easy Dot-Com, Easy Dot-Go,” the smaller companies with the questionable business plans always go first. The analysts have changed the focus from site hits to cash dips. While 1999 gave us an extended party of dot-com IPOs, the hangover in 2000 is now the daily occurrence of bankruptcies and distress mergers. This will continue for some time. Even the clear leaders of the Internet that dominate their space are also being punished by the market, with stocks like Amazon, eBay and Yahoo down 50% to 70% from their 52 week highs.

The only technology stocks that continue to perform well in this decline are the larger Web “infrastructure” stocks, such as Cisco, Oracle and Intel. These are all quality companies, but they are partly dependent on the continued flow of capital into the companies that are now crashing. Also, they are giant companies (in terms of market capitalization), and they currently have high valuations; so growth in future years will be much more difficult, and investors will not be tolerant of disappointments.

We know that investors never like to hear critical comments about their prize stocks, but the probabilities are that the prices of these great companies will provide poor returns over the next few years.

### **CornerCap's Approach to Speculation**

It may be appropriate to have an element of speculation in many investors' portfolios. When we managed the RJR Nabisco pension fund, we allocated a small amount to venture capital funds for our more speculative investments. The problem we experienced in the market during 1999 and through March 10, 2000, was that many private, smaller investors contributed a significant portion of their retirement assets to a lot of companies based on talking heads, chat lines and price charts. For many investors, their lifestyle in retirement has been permanently eroded, and even though a major change occurred in the market on March 10, we do not believe that it is over. The next area for speculative opportunities will be biotech/bioinformatics and the drug developments that will need to be funded. Hopefully, those who can afford the risk will fund these important innovations.

At CornerCap, we believe that the best opportunity for more speculative investments is in the emerging growth sector in which innovative and under-researched companies can be selected before the market anoints them. Four years ago, we started our CornerCap Emerging Growth Fund as a limited partnership investment for several of our higher wealth clients. This more speculative fund represents a relatively small percentage of these clients' overall assets. This month, the fund will do a tax-free conversion to a mutual fund. As you would expect, the fund tends to have heavier weightings in technology, biotechnology, and communications companies. The investment discipline focuses on top-line revenue momentum and improving earnings, and it has performed well over this period. Again, this fund is generally appropriate for only a smaller percentage of an investor's assets.

### **Core Value and Core Growth**

Based on the success of the above investment discipline, we have begun the implementation of a core growth separate account product for a few of our higher wealth clients. While we are following investment disciplines similar to the Emerging Growth Fund, we do not have a track record with this sector of the market. Because of the higher valuations in this sector, this product may have greater downside exposure in the short term. As such, this product is only being implemented as part of an overall asset allocation plan, and it has a lower weighting than the value segment of these client portfolios.

With our core value investment discipline, we have always placed more emphasis on the purity of the analysis than on making sure the portfolio looks like the indexes, i.e., by being a closet index fund. The tradeoff is that our returns should be and we believe have been higher over the long term, but there will be occasions when variations from the broader market indices will be painful, such as during the last two years. With our core growth investments, we are again focusing on the purity of the analysis and disregarding the closet index temptation. Most of our clients have a long-term focus and deserve the opportunity for the higher potential returns that the pure value and the pure growth disciplines offer.

With our core growth investments, we are again focusing on revenue momentum and improving earnings. One difference from our emerging growth investment discipline is that we are avoiding extreme market valuations in the core growth area. We do this because of the numerous academic studies that have shown how difficult it is for large companies (e.g., Cisco) to sustain their growth rate over the next five or ten years. These core growth investments will work best as a complement to our core value investments in that the disciplines will capture the essence of and the differences in each style, and the holdings will be mutually exclusive.

### **The State of the Industry**

As Jack Bogle, the founder of Vanguard, noted in a recent editorial, a lot of people have lost their way recently. We wrote about the many investors who have speculated and are speculating with their precious retirement assets. Portfolio managers for mutual funds turned over their investments 17% per year in the '60s and '70s, and now they have a turnover rate of 90% per year. Individuals redeemed their investments in the mutual funds they selected in the '60s and '70s at approximately 12% per year, and last year the redemption rate was 47%. In the '60s, 14% of the mutual funds failed during the decade as compared to 55% in the '90s. Even though the assets in mutual funds have risen dramatically over the years, the average expense ratio has risen steadily to 1.61% last year. Who do investors think is funding these higher taxes, higher turnover costs and higher fees?

Why have these changes occurred? Where will they ultimately lead us? The problem is not with investors but rather with an industry in which many of the professionals have changed their focus from fiduciary duty to personal financial gain. The above statistics suggest that investors are the targeted victims of the transaction, rather than being the appreciated clients.

The portfolio manager who can create the highest return for marketing purposes will attract the most assets. The fact that the returns tend to be fleeting and the taxes not fleeting are the investor's problem. The mutual fund company that can merge a low returning value fund into a higher returning growth fund will erase the lower return from the record and will attract more assets. The arbitrary change in the shareholder's investment objectives (probably at the worst time) is the investor's problem. Some CEOs and boards of public companies slant the books and hype the stock to extract more capital from their shareholders and enable the managers to cash out their stock options. The resulting loss from the intentionally inflated stock price is their shareholders' problem. This investor-beware environment is not healthy. Trusteeship and objectivity are not being rewarded by the system and are not being properly valued by investors.

Whether CornerCap does it, you do it, or someone else does it, there needs to be a plan for managing your total wealth, whether you are a pension fund, an individual, a foundation, or whatever. Of course, the plan will not be successful without mutual trust, and that trust must be earned, on both sides. This oversight management is what we did for RJR Nabisco and this is what we do for many of our clients. We never manage an account without clear investment objectives. Investors with no plan have no idea where they are going, and if they are not willing to change their focus, we will try to avoid participating in their likely failure.