

FEAR-SIDE CHAT

Thirty-one months ago, investors were euphoric. They told us, "I'm not afraid of stocks." Our unspoken thought, "Well, the stock market is a very dangerous place. It has not seemed so for the last few years, but it always has been, and now it's more dangerous than ever, because people believe it is benign." We were also told, "Technology is still the way to go. It beats everything else over a ten-year period." Our response, "This may be the way things currently appear, but in other ten-year periods other stock sectors led the way. Each of those leaders fell by the wayside. They were simply replaced by the next 'new' thing."

The market decline actually began in March 2000, but by the end of that year, few believed that we were really in a bear market. Now everyone concedes that we had a market bubble. The NASDAQ decline of almost 80% (peak to trough) is one of the greatest collapses in market history. The broad market declined about 20% in the third quarter alone. What is happening? The market is wringing out the excesses created from about 1998. Market psychology is experiencing a reversal from euphoria to fear and panic. At the bull market peak, clients were asking, "Why won't you own the great technology stocks?" Now they are asking, "Why won't you go to cash and get completely out of the market?" Those may seem like logical questions for the times, but they are nonetheless poorly timed.

The Experts Speak

Many investors watch CNBC or read market newsletters. These are the same sources that gave all the advice that led investors into this market debacle, so why should their advice be any better now? CornerCap has always been skeptical of experts, but we do value a few people's opinions. They include Warren Buffett and Bill Gross. Buffett is famous. He has become the second richest man in the world through investing. Bill Gross is less known outside financial circles. He manages about \$320 billion (yes, billion) in bonds at PIMCO. Bill Gross has compiled a record in bond investing that is unsurpassed over 20-plus years with PIMCO. The Buffetts and Grosses are not infallible, but they certainly deserve attention because they have been so right, so often, for so long. They have cautioned us for nearly three years about the stock market. For some rational guidance, we examined three different methods of valuing the market.

(1) The Warren Buffett Approach

Over many decades the economy has expanded with surprising consistency, at a rate of about 2.8% over inflation. Historically, the total US stock market has been priced in a range of about 45% to 85% of GNP (Gross National Product). Stocks can grow faster if profits take a greater piece of GNP (not sustainable for long) or inflation declines, giving a price/earnings ratio increase [inflation is about as low as it can get now; if it goes below zero, that causes a whole new set of problems for stocks]. In 2000, stocks got way out of line with GNP, above twice the normal range. The current ratio of GNP/market is approaching a normal range again, i.e., 85% of GNP. If you buy stocks when this ratio is at 85% or below, you have a pretty good chance of making a decent return over several years. If you want great returns every quarter, you are going to be disappointed. Money invested as this market continues to decline may not give a good return next quarter or next year, but it should give a good return over the next ten years.

(2) The Bill Gross Approach

Bill Gross looks at the historical relationship between S&P 500 Index stock prices and earnings over a 130-year period that included six other technology driven eras of market “exuberance.” In early 2000, the market moved to a price that valued a dollar of earnings by over 50% more than the normal valuation. This was a clear indication that people were carried away by their expectations for future market growth. Because of the almost 50% decline in the broad market since early 2000, the valuation of the market has moved much closer to reality. However, Gross still believes that the multiples are too high, dividend yields are too low, and corporate earnings are too “mystical.”

(3) The Dividend Discount Approach

The dividend discount model is based on the concept that a stock is worth the future stream of all dividends that the stockholder is going to receive over many years, including the terminal value of the stock. Discount these dividends back to a present value, and you will have the “fair” value of the stock. The mathematics are simple, but the inputs have many assumptions—how much profit the company can make, how fast the profits will grow, for how long, how much of the profit the company will distribute in dividends to the shareholders, and, most important of all, what discount rate should you use on the dividends to make sure they give you a return that is satisfactory? If you change any of these numbers, the “fair” value can change by 20 to 30%. But the model can still give some broad idea about fair value. Near the end of 1999 when the S&P 500 Index was at 1450, you just could not make the fair value come anywhere near that index value, no matter what reasonable assumptions you used. The best that you could have expected to earn over the next ten years would have been in the +3% to –3% per year range. But investors believed that they would get 15 to 25% a year, because they had been getting that kind of return. This was the rear view mirror approach to investing—what you see in the rear view mirror is what you can also expect to see up ahead. It did not work then for the newly minted optimists, and it will probably not work now for the recently converted pessimists.

Results of the Three Methods of Valuation

These three valuation methods are all giving similar conclusions—the market is at the upper end of the buy range, i.e. still not cheap. But these are only broad indicators, not exact numbers. Given 2% inflation and an economy that is slowly improving, despite the technology wreck, we would estimate that the S&P is priced to give an expected return over the next ten years of around 7% (5% real return plus 2% inflation) per year. This is slightly below an historical average return, and with a 10% decline in the market from here, the expected return would increase to 9%, very much in line with history. If the market continues to fall, it will move into territory that can provide a good expected return, though probably not above 10% a year. Except for a continued, dramatic drop in stock prices from the current level, there is no reasonable set of assumptions that can make a case for 15 to 20% annual returns into the future.

CornerCap Outlook

We do not know what the market will do from here, but there are a few market principles that we use to guide our investment approach. Market psychology plays a role in stock prices. The efficient market is not quite as efficient as the academics would have had us believe. Just as prices went to extremes on the upside, they can go to extreme under-valuation. The psychology of a bull market is that it rises, climbing a “wall of worry.” Skeptics doubt that a rise in the market is justified in its early stages, but stocks continue to climb. Finally, at the peak, there is no more worry. Investors see only a rosy economic and market outlook. In fact, “Rosy Scenario” is one of the most provocative, deceptive, and dangerous ladies you are ever likely to meet.

With bear market psychology, investors start with minimal concern. Market declines are punctuated with abrupt rallies that push stocks up temporarily. Investors continue to slide down this “slope of hope” believing that the market has reached a bottom and will soon recover to its former highs. At some point, hope gives way to despair. Most investors sell, believing that stocks can never go up again. Many will never again invest in stocks. The cycle is complete and stock prices have a margin of safety for the first time in years. But most people will not want to own stocks. They will be sellers in a big way. They will then wait patiently until the market moves up to a high level. They will feel comfort that stocks again are doing well, and they will buy, just in time to lose money all over again. Remember, it is far more comfortable to lose money along with the crowd than to make money betting against the crowd.

CornerCap Investment Strategy

People naturally ask, “If you know this to be true, why didn’t you sell at the top, waiting to snap up bargains at the bottom?” Our concern, “Nobody can time the market.” Yes, broad patterns of market behavior repeat, but each time is different enough to keep investors from capitalizing on them. Just as we did not know “how high is too high” in the bubble, we do not know “how low is too low.” If past market history is any indicator, then trying to sell and buy back later will almost surely be a losing proposition.

While we do not know how low is too low, there are some things we do know. We know that the economy has been weak for some time and that stock market bottoms almost always occur before the economic recovery begins. So it typically pays to be invested early relative to a business recession. Based on an analysis of the stock market returns over the last four bear markets, we also know that those who invested six months before the market bottomed realized a 20.7% average return over the next 12 months. However, those who invested six months after the market bottomed only realized an average return of 4.9%. So, it usually pays to be invested early relative to the always-unknown market bottom. In other words, those who are thinking about abandoning stocks now should think again.

As difficult as it is, you should continue to commit funds to individual stocks that are at more favorable ratios than the market in general. CornerCap is constantly searching for stocks that sell well below fair value, regardless of the market environment. Even if we find them, there are times when the market will carry them significantly lower. We cannot control that. But our stocks have performed exceptionally well since the market crash began in March 2000, with our small-cap stocks still up nicely, and our large/mid cap stocks only down modestly—all of the decline occurring in the last quarter. This compares to the 2.5 year returns for the S&P 500 (large cap), Russell 2000 (small cap) and NASDAQ indices of -43.8%, -32.8%, and -74.4%, respectively. Our portfolios have preserved capital.

The bear market of 2000-2002 has been at least as bad as the great bear market of 1973-1974. The principals of CornerCap have managed the Carolina Equity Fund L.P. account over this entire period, and we realized some of our best returns in the years following the 1973-1974 decline. We hope we will be that fortunate again when the market turns.