

### Market Outlook

As most of our clients know by now, we are seldom inclined to make a market forecast. We do not even like to provide an “outlook”—a broad overview of the future course the market might take. We recognize how futile such efforts usually are. Market forecasts are interesting most often after the fact to see just how wrong they were. Over the years they really do not add much value to the investing process.

We believe that it is much more important to be in the market and in the right kind of stocks than it is to try to guess which way the “market” is headed. This is true, if for no other reason than that it is a lot easier to pick stocks than to time the market. Stock picking also seems to pay off better than market timing. Even on those rare occasions when we have shared our ideas about the future, we have been inclined to follow the best advice that forecasters ever got: “When forecasting, pick a number or pick a date, but never pick both.”

Nevertheless, it might be instructive to compare the current market environment to the historical market for some clues about successful, and unsuccessful, investing in the next few years. The market averages have been rising, quite dramatically, for a year now. For the 12 months ending September 30, the S&P 500 has returned 24%, and the Nasdaq

has returned an astonishing 53%. All this is coming off a very bad bear market. Even with this strong recovery, the S&P 500 has still declined about 24% from its peak over three years ago until September 30, 2003. The Nasdaq has declined 63% from its peak, and was down more than 75% at its worst in late 2002. The Nasdaq has experienced one of the most devastating declines for any market index in this century, rivaling the decline of the Dow Jones Industrials in the great bear market of 1929.

It is always dangerous to draw parallels to history and expect that the events will repeat. They almost never do repeat, at least not closely enough for us to make any money by betting that they will. But the current market does have some similarities to the market during and following the last great bear market, 1973-1974; in about 22 months, the S&P lost 40%. Stocks staged a major rally in 1975 and 1976, with the S&P's rising 70% over this two-year period. It is what happened after that strong rebound that interests us most. For the next six years, the S&P stayed virtually flat. It paid a respectable dividend, but there was no stock appreciation from mid-1976 to mid-1982. That's right! There was almost NO gain.

We have been in a major up market since October 2002. It may turn out to be very similar to the move in 1975-1976. And what happened after 1976 may be similar to the outlook today. During those six years when

the S&P 500 went nowhere, an examination of the performance of non-S&P 500 stocks is a bit surprising and encouraging. From June 1976 until June 1982, small-cap value stocks, had a 20+% annualized return for those six years. During most of that period, the founders of CornerCap were in partnership managing the [Carolina Equity Fund](#), and we realized similar returns, 27% a year from September 1979 to June 1982. In short, it was a period in which you could not just mindlessly buy an S&P 500 Index Fund and do well. You had to pick individual stocks, and you had to pick mostly from a universe of small, less known companies.

There is evidence to support the idea that we might be entering such a period again. One indicator is the price/earnings ratios (P/E) of various market-cap sectors. It can sometimes be helpful to look at the P/E ratios of stocks for clues about their relative value. The chart below shows the range and closing P/E of the S&P 500 Index each year from 1987 to 2002. Note that the ratio moved steadily higher until the peak in the market in 1999, and then it declined in 2000. But for 2001 and 2002, the ratio began to rise again. This was not because stocks were going up in price but because earnings per share were falling faster than the stock prices. It is important to consider the composition of the S&P 500 Index as we consider this chart. Remember, this is not an index that equally weights all 500 companies—far from it. It is

## Commentary September 30, 2003

“capitalization weighted” which means that big companies like Microsoft and General Electric dominate the index because they are many times larger than the size of the average company in the index.

The current P/E of the S&P 500 Index is 29.7, while the median company, that is the company in the middle of the pack, has a P/E of 19.5. This shows that the largest companies are carrying a much higher P/E ratio than the smallest companies. The average P/E over the entire 16 years has been between 20-21. While the index is well above the historic average, the universe of

companies is at, or just below, that long-term trend line. By most historic measures, the stock “market” is still not “cheap,” but there are many individual stocks within that market that are selling at prices that are attractive. Also, we need to add that the overall market continues to sell at a P/E ratio that is above the very long-term historical trend. These somewhat higher valuations overall reflect the fact that interest rates are very low now. Because of these low interest rates, fixed-income instruments offer somewhat less competition for stocks now than they did in most of the period we are examining. This

may justify P/E ratios higher than the historical norm.

Now there is a situation when, based on value, small stocks may outperform large stocks for some time in the future. This could again be a period when the S&P 500 Index does not advance much, but small companies do well. We have included some projections of the P/E values for the years 2003-2004. This data reflects an expected increase in the earnings, but does not change the current stock prices. In this environment, the stocks with lower P/Es have an opportunity to outperform large stocks. Even if their earnings are not growing as fast as large stocks, the small stocks are starting at a deeper discount in valuation.

Further, when you consider the stocks that we own at CornerCap, the average P/E ratio for our holdings is 14.6, a discount of over 25% to even the median of the 500, and a discount of 50% from the S&P 500 Index. We are doing what we consistently do, that is, searching for stocks that appear to be selling below their relative value in the market.

There is no assurance that our strategy will be as successful this time as it was from 1976 to 1982. In fact, there is no assurance that the market will even follow the broad scenario we have described here. But we are comfortable with our positions in such stocks. While nothing is certain about the outcome, we are certain that the probabilities are on our side.

