

## **Running Down the Run Up**

One can't help but enjoy reporting excellent investment results to clients. CornerCap's equity returns for the quarter were not only up significantly in absolute terms, but they were also well ahead of the broad market indicators. While CornerCap's returns have consistently done well since the crash began, the overall market has experienced a dramatic turnaround. It was just last quarter when we were counseling about excess fear and pessimism, and we predicted reasonable, although single digit returns, for the market during the remainder of the current decade. However, we did not foresee such returns coming so quickly, and we do not see the economic justification for this one.

Was this equity run up a good thing? Assuming that we are all long-term investors, is any market advance a good thing, even without economic justification? After experiencing the last three years, we hope that a sufficient number of investors have learned the implications of speculative investing. Absent economic justification, your gains are not long-term, only temporary, and some must be given back. We apologize for always busting up the party, but it concerns us when we see the market move too far too fast, in either direction.

One thing we've noticed about the market (and most things in life) is that there are always two, usually passionate, opinions. Even at the peak of the market in March 2000, there were two ways to view expected future returns, although we had enormous difficulty seeing one of those views. We will try to objectively present the two opinions that are before us today and then wind up with CornerCap's position.

### **The Optimist**

Bear markets do end, and the next bull market follows. Defining a bear market as a 30% decline, there have been 10 bear markets since 1929. The average decline was 44% and the average duration was 14 months. Our most recent bear market saw a peak to trough decline of 49% as measured by the S&P 500, and it lasted 31 months. The long drought should be coming to a close, and, given the significant market advance that started in April, this change in direction may be for real.

The economy appears to be recovering. Except for unemployment, the key indicators seem to be improving. Consumers are still spending. Earnings have turned positive, and projections are for accelerated earnings growth this year and next. The decline in the dollar should support these rosy forecasts as our businesses more cost effectively manufacture and export products. The Fed continues to hold interest rates down, and this is helping to support real estate valuations. Most economists believe that there is little risk of triggering deflation, and all indications are that inflation will remain low. Our pro-business bureaucrats have taken significant steps to kick-start the new expansion with both their monetary and fiscal policy moves.

Most of the optimists believe that the market is no longer overvalued. Using 2003 projected operating earnings, the S&P 500 is currently trading at 19.2 times earnings, and many feel that this is a buying opportunity. Historically, when inflation has been at 2% or less (i.e., where we are now), the price/earnings ratio for the market has averaged over 20. These investors would argue that because of the three-year decline in stock prices and the depressed earnings that have been reported, the market is either fairly priced or under priced.

We are an information economy, and this requires that we realize some growth in technology. Recoveries from bear markets are typically front-loaded, with the initial 12-month return from the market bottoms

averaging +47%. The war is over and this is a great country, so invest now before you miss the entire blast-off.

### **The Pessimist**

From its bottom in March of this year, the S&P 500 climbed over 20% through quarter end. The S&P is now 32 times trailing earnings and the NASDAQ's multiple is in triple digits. This compares to a historic average market P/E in the mid-teens. This is the third year running that the sell-side firms (i.e., Wall Street analysts) have told us that earnings were depressed and that a dramatic recovery was just quarters away. Maybe the third time is the charm, but we wouldn't bet the ranch on it. It will take more than the "global settlement" from the class action lawsuits to dampen the optimist's enthusiasm.

There are only three things that can significantly change the value of stocks. The following is how the pessimist view these investment factors:

1. Price/Earnings Ratio change -- We saw a dramatic change happen from 1982 to 2000 when the multiple on the S&P 500 climbed from 8 to around 40 times earnings, culminating with the tech bubble. At 32 times earnings, the multiple still needs to come down from its current lofty level. The best scenario would be for this to happen slowly over time as earnings grow.
2. Interest Rate change -- Stocks and bonds compete for investor assets. As the interest rates on bonds decline, stock investments become more attractive and typically appreciate. Since 1981, we have seen the yield on 10-year Treasury bonds decline from 14% to 4%, hitting 40-year lows. The optimist would correctly point out that stocks perform the best when rates are low, as they are now. The pessimist would just as correctly note that interest rates go through cycles and that they can't go much lower. Rising interest rates may trigger a fear of inflation, which would be damaging to the equity market.
3. Corporate Earnings change -- The final item that can drive stock prices substantially higher would be a growth in corporate earnings at a rate over time faster than GDP. This is our last hope. Most professionals recognize this fact, even the eternal optimists. Earnings will increase over time, but the question is when and by how much.

Historically, earnings have grown at around 4.5% to 5% a year, slightly below GDP. With current dividend yields at 2%, earnings growth at this historic average would result in a total equity return of 6.5% to 7%. To realize a 10% expected market return, earnings would need to grow in the 8% a year range. This is 60% greater than what companies have done historically. Investors expecting returns in that range are probably going to be disappointed.

### **The Realist**

If you've managed to read this far, you are probably a regular reader of our position papers, and you know where we stand. We always try to be practical, unemotional realists when it comes to investing. We pay attention to human behavior, but we are always long-term and numbers driven.

We have noted for some time in our reports that the S&P 500 stock index was not cheap. This condition worsened last quarter as the index appreciated 15.4%. If the market should continue to run at this pace, we can almost guarantee a back-to-the-bubble scenario. Our hope is that the market will not continue at this pace.

Maybe a 7% equity return is a good return for the average investor at a time when bonds are yielding 3.5%. It takes time to recover from a bubble hangover, especially the whopper most investors have had. Pre-bubble expectations will continue to converge with post-bubble reality until they are again moving

down the same path. Our hope, and the concern that we are addressing here, is that we can avoid major bumps along the way.

For the patient, disciplined investor who is unwilling to pay inflated prices for unrealistic earnings expectations, “the market” has become much easier to outperform. Our equity portfolios are trading at less than 13 times 2003 earnings, coupled with reasonable growth projections. While we do not believe that we will be able to replicate our mid-teen returns of the 80’s and 90’s, we do believe that the market continues to present excellent investment opportunities for us to create reasonable and above-market returns for our clients over time.