

The Business of Moneymaking

As in the movie “Cocktail,” investors are again starting to sing that old favorite “Don’t Worry, Be Happy.” After three down years for the average equity investor (CornerCap was only down in one of those years), the market is again flying high. On such occasions, as our long-time investors know, we work to keep our clients and ourselves well grounded. In the bull market of the 1990s, the mood for making money effectively masked some shameful behavior by the perceived moneymakers. As investors decide to start opening their monthly statements again, we wonder if the gains will once again mask the shame? Hopefully not.

The business of making money has become big business—advisers, brokers, consultants, planners, analysts, etc. Investors tend to focus more on the rear view mirror than on the front windshield, evaluating their recent results rather than the inter-workings of businesses. The structure of businesses will directly impact investors’ future results. As we have clearly seen (note: Bank of America/Canary, NYSE/Grasso, CSFB/Quattrone, Putnam, Strong, Pilgrim Baxter, etc.), we need to know how the moneymakers are motivated to make their money. According to Murphy’s Law, “If everything appears to be going well, you are most probably not aware of everything that is going on.” Our modest goal is to raise that awareness.

Making Money for Whom?

What kind of work do you do? Our job is to manage the investments of institutions and individuals. What motivates you to be the best that you can be at your work? Our job is mostly about money. People want to know whether CornerCap’s investments make more money than investing in some index, some fund, or with another adviser. If we have made more money than these alternatives (adjusted for risk), then we become popular and receive greater recognition, primarily in the form of more money. This is how our success or lack of success is measured by the world outside our offices. Should that also be the standards for measuring success inside our offices?

We believe that staying focused solely on making money will in fact end up being counter-productive. We see examples of this everywhere today. Sales people receive commissions for maximizing the dollars brought into their firm. The quality of the clients or the match between clients’ needs and a firm’s services are often disregarded or rationalized away. Investment professionals receive annual bonuses for producing returns over an appropriate benchmark. These bonus formulas vary, but they frequently result in the investment professionals’ being more short-term oriented, creating greater turnover, and focusing more on the benchmark than on the investment fundamentals or on what is best for the client over the long term. We even see this misdirected behavior in the back offices of firms because of the motivation of money, as supported by the recent rash of indictments in the mutual fund area.

The lack of money can certainly be a de-motivator, but we would argue that money is not the best motivator for doing a quality job over time. However, money can clearly be a behavior modifier in the near term. The last few years highlight this short-term phenomenon. As we exit another year of scandals, we have seen an endless stream of front-page articles that illustrate the downside of excessive economic incentives. The people in these articles defined “winning” as doing whatever it took to make the most money possible for themselves and their firm. This attitude was well articulated by the Bank of America employee who was terminated for managing the bank’s clearly unethical mutual fund practices when he said, “I didn’t do anything illegal.” That position will be decided in court, but it is also the same

declaration that is being made by the various CEOs, investment bankers, and hedge fund managers who are currently on or about to go to trial.

Frequently, it is an employee who is on trial, but CornerCap places the greater blame on the firms themselves. It was the CEOs and boards of directors who created the incentives and administered the rewards and punishments. Their firms lacked the internal controls to police the system and to eliminate any unethical or illegal activities. Of course, the entire industry breaks down when we learn that it is those leaders of the firms that have exhibited this unethical and illegal behavior, for example, what we have seen with the Strong and Pilgrim Baxter mutual fund companies. We cannot rely solely on the courts and regulatory authorities to administer the proper punishment. Investors need to vote with their dollars, hopefully resulting in sufficient disincentives to begin righting the myriad of wrongs in our free market system, which, as bad as our problems may be, is the best there is.

Bigger is Better for Whom?

In recent years, acquisitions have been playing a more significant role in the business of moneymaking. Similar to the motivational problems discussed above, we believe that most of these acquisitions in the investment business reflect a mismatch of the business owners/managers' objectives with their clients' long-term objectives. Large investment firms (recently mostly banks) have been acquiring small investment firms. In Atlanta, there has been an epidemic of midsize investment firms', like CornerCap, being rolled up into large banks. These rollups create significant economies of scale for the larger institution. They also create big bonuses or other financial payouts for the acquiring managers and the acquired owners. Does the customer also benefit? Does the acquisition result in better decisions and improved service? The answer illustrates an important myth, which is that bigger is better. With these acquisitions, the buying company has the capital to make the purchase, and the selling company has the investment innovation and dedication to client service to have been attractive to the acquirer.

Certainly, the large banks noted above bring unlimited financial resources to problems or products or people or whatever. These enterprises have enormous economies of scale. If they lack something, they can buy it. If they have poor performing products, they can pull them from the shelves, find good performing new products, and aggressively promote them. If they have poorly performing professionals, they can terminate them, find the best talent on the street, and offer economic incentives that push them to maximum production. Sounds good. Maybe bigger is better!

To counter what may appear to be the obvious, most studies have shown that small investment firms more often realize better returns than large firms. We attribute this to a more entrepreneurial attitude with small firms. The business ownership and the attribution for successes can be felt very directly in a small firm. Once ownership is sold to a large firm, the motivation to continue to excel typically declines. Another cause for the lower returns realized by large firms is the liquidity factor. Because of the large pool of assets they have to manage, large investment firms are essentially forced to buy large stocks. This constraint tends to drive them in the direction of a closet index fund, i.e., restricted to only high-capitalization stocks. Small firms simply have more flexibility.

As a general rule, we at CornerCap do not believe that most things work well on the extremes, whether you are talking about wealth/poverty, intellect/ignorance, spiritualism/atheism, etc. The same is true with bigness in the investment management business. In our prior experience at RJR Nabisco working with outside managers, we found that the only large firms that could create good returns and service were those that (1) had a strong, consistent culture that had evolved over many years and (2) were structured to behave like a smaller, more entrepreneurial firm. This is easier said than done.

All of the mergers and acquisitions that enabled most large investment firms to become larger have worked against the creation of a common culture. Also, based on our experience plus a little common sense, the larger the investment firm becomes, the less it operates in an entrepreneurial manner. We

believe that entrepreneurial sharpness transitions to bureaucratic dullness as the number of investment decision makers grows.

We have found that the successful investment firms, regardless of their size, have only a few key decision makers who are responsible for maintaining a consistent philosophy and process at the firm. This observation is supported by a recent survey conducted by Casey, Quirk & Acito, LLC, in which it asked participants what resource characteristics were the most important contributors to investment quality. Of the eight characteristics listed, a “large research staff” received the fewest votes, just 1%. CornerCap is committed to this philosophy of concentration and continuation of key decision makers by passing along equity ownership of the firm every year to its key professionals. Long-term equity ownership is the only device we know of for properly aligning our objectives with the long-term investment objectives of our clients.

We have presented how we believe investment clients should view the recent rash of rollups in the investment business. Internally, how do we view this migration toward larger investment competitors? We do not even see ourselves as in competition with these firms. Our view, at least the one that we preach to each other, is that we are only in competition with ourselves. Each individual at CornerCap, from the investment professional managing portfolios to the administrative professional serving our clients coffee, must always be striving to improve and be their very best. If everyone on team-CornerCap can make that his/her challenge, then we are winners, both as individuals and as a group. It truly does not matter who buys whom or becomes how big.