

Revelation and Response

Recently, a well-known investment consultant characterized a CornerCap exploratory presentation by exclaiming, “revelation and response.” That was his intuitive reaction after reviewing our investment research data and performance results. It was his thought that CornerCap’s pattern was to encounter revelations and then to respond to them by adjusting our investment process.

Does this willingness to modify our investment process run counter to recent commentaries in which we have noted our close adherence to the investment principles of other investors such as Ben Graham and Warren Buffett? No it does not. These are great teachers whose investment philosophies are permanently consistent with CornerCap’s. However, a successful investor’s process is usually not stagnant. Successful investors should always be learning, growing, and willing to improve their process.

With investments, how do you learn and grow? We hope that our clients learn something from us. We have learned a great deal from other investment professionals, especially buy-side investment advisors whom we hired while managing the RJR Nabisco funds. We have also learned from investment consultants, such as the one noted above.

Most importantly, we have been self-taught. We have done our own research since our inception, choosing not to rely on Wall Street research analysts and other generic research products.

Advisors’ Advice

While we have known many advisors, few of them have warranted our full attention in the study hall. One of them is Capital Guardian (The Capital Group), one of the most successful of all advisors and one that we hired at RJR in 1978. Capital Guardian was created in the 1930s and has survived and thrived through many investment cycles. What we learned from them was the human implications of following a contrarian investment philosophy.

When we bought into their contrarian investment approach, they had excellent investment results. They had built a reputation for a strong discipline and solid philosophy during the early 1970s in the Nifty Fifty growth stock bubble. Many companies had terminated Capital Guardian in 1972 when they refused to follow the parade of other investment firms buying the Nifty Fifty stocks. Of course, from 1972 to 1978, their investment returns were exceptional because of their contrarian philosophy. Coincidentally, at about the time that we hired

them, a new bubble was in its formative stages.

In November 1980, at the peak of the oil crisis, we walked into Capital Guardian’s New York office on Park Avenue late one afternoon for a quick visit. The office was fairly deserted. To our surprise, a portfolio manager whom we knew from San Francisco was alone at a desk. He said that he was in New York City for a client meeting. With a very concerned look, he confessed that he was sure he was going to be fired by the client for not owning any oil stocks!

To put things in perspective for those who cannot follow all the bouncing bubbles, since 1973, oil prices had been raised by OPEC from \$2.50 a barrel to \$37 a barrel. In 1980, there were gas lines in California and fears that they would spread across the entire country as they had in 1973. Everyone in the investment business was frightened not to own oil in his portfolio. It had begun to look as though oil might be the only thing worth owning. Oil stocks were 35 percent of the S&P 500 (the same level that technology stocks reached in early 2000). We met with several other investment advisors on that trip to New York, and they were all projecting oil prices of \$100/barrel in the next few months and were heavily concentrated in energy.

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We do not know whether that client fired Capital Guardian that day, but if he did, it was one of the most ill timed decisions he could have made. At that time, the principals of CornerCap were managing the Carolina Equity Fund and were relatively newly minted contrarians. They immediately sold all of their energy related stocks. The oil stocks continued to go up, 15% to 20% in about two weeks. Then they dropped for the next 18 months as world oil prices plummeted. It was ten years before some of the energy stocks regained their 1980 prices.

We appreciated the Capital Guardian portfolio manager's concern for his firm's reputation and for the welfare of his client who was about to make a big mistake. Our appreciation continues to grow over the years as we maintain a painful, contrarian mindset. Most recently, we experienced our first net loss of clients in 1999 and early 2000 during the tech bubble, and we sadly knew where these friends and clients would be moving their assets. We have found that revelation and response in the learning process are somewhat finite and straightforward with investments but that the human implications seem far more infinite and complicated.

Self-Schooling

While we have closely followed and learned much from the great masters of our

profession, we have also learned much from our own internal engineering at CornerCap. When the consultant noted above exclaimed his own revelation about our firm, he was reviewing our Fundametrics® quantitative research process. He was impressed with our process for verifying the success (and sometimes lack of success) of our formulas and our accumulation of two decades of weekly investment returns for our most senior algorithms. What are a few of the things we have learned over the years from our investment engineering?

We have learned that demanding low price/earnings ratios (P/E) for all of our stock holdings is a winning strategy during most years. We know that cheap stocks with low expectations win more often and with less downside than expensive stocks with high expectations. We have also learned that a good earnings momentum formula generates even better gross returns than low P/E criteria. However, the earnings momentum formula results in higher turnover, and higher turnover comes at a cost that is typically underestimated. The higher commissions, spread costs, and taxes (for taxable investors) will significantly and negatively impact their returns.

We mention the above two valuations because they dominated our initial stock screens when selecting stocks in the late 1970s and early

1980s. Since then, we have added other valuations, such as price to free cash flow, growth to value, internal growth rate, etc. We average these valuations together to come up with a single, long-term composite, which is the primary yardstick we use to discriminate between the expected winners and losers. We carefully measure the returns and other characteristics for our key valuations. In our revelation and response process, we sometimes learn that a formula or a data item contained in a formula is no longer adding value to the process, and we will respond by making a change.

In the mid 1980s, we changed the weighting algorithm for our composite valuation. Rather than using an equal weighting for the six models that form our composite, we developed a dynamic weighting. In measuring the returns with each of our valuation models, we have learned that the recommended buys outperform the recommended sells over time. We also know that, in general, these valuation models go through cycles, sometimes doing really well and sometimes doing not so well. Our dynamic weighting looks back over history, recognizing this cyclical nature, and overweights the valuations that have performed poorly (i.e., assuming that they will do better in the future) and under weights the valuations that have performed well (i.e., assuming that they may soon run out of gas).

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We have had recurring revelations and responses with our dynamic weighting. The first was that our earnings momentum model was consistently outperforming the other models, which were susceptible to a cyclical pattern. This meant that this model was seldom out of favor and would almost always be under weighted. We responded with an adjustment. We later learned that our weighting algorithm placed too much weight on current data and not enough on history. We responded with another adjustment. As we do more work with our extensive proprietary database, we anticipate more adjustments. This must be a continuous process of learning and growing.

Trust But Verify

On October 1, the cofounders of CornerCap celebrated their 25th anniversary of investing together. They are both engineers with MBAs, and their passion for investing has always been more fun than work. The more dramatic learning curve has been with deciphering the oftentimes miscued behavior of investors, which admittedly is not the cofounders' passion but certainly a fascination.

The investment profession attracts some of the brightest and best people out there. We have also noted that there is no shortage of self-interest and greed in our business. After years

of study, we have concluded that giving brilliant, hungry people a microphone can be very dangerous to mankind.

These smart people herded into the Nifty Fifty stocks in the early 1970s. They also tried to push our managers at RJR in 1980 to a greater investment in oil stocks. We saw the same thing with our CornerCap clients and the tech/growth stocks in 2000. These smart people promoted a permanent fix to the problem of negative returns with portfolio insurance in 1987, resulting in Black Monday. So, where are these smart people today?

For most investors, returns have been negative over the last five years. These investors are also facing projections for weak returns in the traditional markets over the next few years. The marketplace is displaying an unacceptable behavior, so these smart people are finding new solutions, requiring only that you change your investing behavior.

The solutions are too numerous and our space too limited for a detailed critique of the hottest new ideas. Let's just say that we now have 7,000+ hedge funds, and these unregulated funds can go anywhere to find the desired growth. These funds blend with other solutions to the unacceptable returns problem, such as fund of funds, absolute return strategies, expanding portable alphas, private

equity funds, plus a number of other enticingly labeled ideas.

Do not get us wrong. We realize that there are strong academic arguments supporting these vehicles, and we seek and embrace the revelation of new investment ideas. Our response is that we have learned to be skeptical of these self-promoting ideas that target the current pains and passions of investors. With these potential investment WMDs being floated in the marketplace, we recommend caution and a "trust but verify" approach. In this business, keep in mind that common sense beats brilliance, practicality beats passion, and buying reason beats being sold excitement.