

The Character of an Investor

Hmm. What happened? Is the ride over? Are we pulling into the station? Do you want to get another ticket?

What a joy ride! The market went straight up in the 1990s and then came crashing down in early 2000. After a three-year free fall that left investors' hearts a fluttering, the market just as quickly slammed the bottom and bounced straight up again in 2003. And now, this year, 2004, we have seen nothing but Dullsville.

For the first two quarters of 2004, the S&P 500 Index was up 1.2%. It is very peaceful out there. Where we used to see dramatic differences in the returns from the various indices (growth vs. value; large vs. small) and economic sectors (e.g. technology vs. whatever), most of those market segmentations have converged. The financial editors are having a difficult time getting space on the front page. Greenspan's long telegraphed ¼% increase was the most exciting event they could muster.

Being long time Dullsville residents, we find this environment most pleasing. Just

like granny at the fair, we have found great pleasure (and profits) in watching others thrill with the ride, the excitement of all the cycles and turns. With so many people in line to buy a ticket for the next ride, how long are we to remain in this peaceful state? Probably not long.

Intelligent Formulas

As we have noted in the past, there is an army on Wall Street whose job it is to keep you out of Dullsville. You know these people. They are paid to peddle financial products and services, and, to do this, they must create an atmosphere of excitement. They must convince you that they know where the market is headed next. They know that, in times of greed, they can make lots of money, and, in times of fear, they can make lots of money. Dullsville is not where they want you to be.

As Ben Graham said in his book, *The Intelligent Investor*, first published in 1949, "Nearly everyone interested in common stocks wants to be told by someone else what he thinks the market is going to do. The demand being there, it must be supplied." This was true then, is

true now, and will be true forever. For those who are not familiar with this author, Mr. Graham is considered the father of security analysis, and his text is considered the "bible" in our industry.

At CornerCap, we are also most interested in the dramatic events that are to unfold in the market in the coming months and years. It is our job to be in the right place at the right time. We will not always be there, and neither will other investment advisory firms. We were not there during the tech bubble, an event manufactured by the aforementioned Wall Street peddlers. However, over the last four years, the market has rewarded CornerCap investors while most other firms were taken to the woodshed for their past sins. How much longer will the market continue to favor our investment style?

Like Graham, we have a series of formulas that we use to ensure that we will be successful investors over time, but we guarantee that we will not be successful all the time. Our formulas are not overly complex; neither were Graham's. The magic is not in the sophistication of the formulas but in the logic of their selection and the consistency of their application.

Some of our formulas are essentially copies of Graham's and some are not. While Graham's investment concepts are timeless, specific calculations must be updated to reflect the evolution of the business environment. But, as we do, Graham recognized the problems that many investors have in this area. Quality investment research requires that one have a clear understanding of the past and be realistic about the present. However, simple principles can be problems in practice. We will share more of Mr. Graham's ageless investment wisdom in future articles, but we will say for now that our formulas will govern our behavior.

The Independence Paradox

We can't tell you how much longer the market will remain in Dullsville. However, we will make the prediction that the relative swings will not be as dramatic as we experienced in the late 1990s tech bubble. We will also predict that when a swing comes, we will be unable to clearly define the cause until we are well into it. Moreover, we will not know when it will end. Extreme market dislocations are

typically motivated by the masses, and mass psychology is always hard to predict.

How much longer will the market favor CornerCap? We don't know that either. We do know that, during those times when we are out of step with the market, some clients, consultants and prospects will criticize us. This criticism may be about our returns, but it will also be about our apparent disregard for the immediate "action" that is taking place in the market. We share Ben Graham's thoughts on the irrelevance of this market noise. He said, "you are neither right nor wrong because the crowd disagrees with you. You are right because your data and your reasoning are right." Therefore, what we need to be doing is continually updating our formulas and following our disciplines.

Graham's central theme in the above quote and throughout much of his text is *independence*. Most investment advisory firms like CornerCap consider themselves independent. This is a relative term. We would argue that most are not independent. It is an odd behavioral paradox. In general, investment advisors know that independent thinking will

significantly enhance their returns over time. The purchasers of the investment advisor's products also know and agree with this principle. Since known by all, what's the problem?

Independence, even among experts, is forfeited in curious ways. In the institutional world, the consultants and plan sponsors teach independence in the course lesson, but on the final exam, they want to know your information ratio, correlation and standard deviation as compared to the benchmark index that you have been assigned. It is acceptable to be at or above these measurements, and maybe even slightly below, but no time period should be significantly below.

From an investment perspective, it is important that the investment advisor always behave in an independent manner, which means that these relative-to-benchmark measurements should be disregarded in the investment process. The advisor should only focus on valuation and risk. In other words, being independent means that the advisor must accept periods when he totally flunks the exam.

Of course, the more dependent the advisor becomes on business from the consultant(s), the more he will do to come close to average on the exam. This benchmarking process ends up handicapping investment advisors and driving them toward mediocrity. Stated another way, the institutional buyer is forcing the seller, i.e. the investment advisor, to compromise his independence. The paradox is that the buyer and seller have colluded to turn a basic advantage (independence) into a basic disadvantage (dependence).

There is a similar problem in the world of individual investors. For many individual investors the benchmark becomes, not an index, but one's friends at the club, at church, or just what the guy on the TV says. The problem is that we are our own worst enemy. Most investors are destined to buy high and sell low.

Graham made the point that investment professionals should not focus on creating the optimal investment results for clients but rather on investments that are psychologically feasible. Our translation of this principle is that it is incumbent upon us to properly assess our client's

psychological risk profile and to make sure that our investments stay within that relatively narrow range. This ensures that the client can stay the course over the long term. For the individual investor, the risk profile typically relates to an absolute investment return. For the institutional investor, the risk profile may relate more to a relative-to-benchmark return.

An Investor's Character

As we coast through the calm waters out of Dullsville and into the choppy seas that we know are on the horizon, it is beneficial to hone our navigational skills by studying the great masters whose principles have weathered the test of time. In our opinion, Ben Graham was the most proficient, all-around teacher, mastering both the academics and the practical aspects of investing.

Maybe the most important term in his original book, *The Intelligent Investor*, was his definition of "intelligent." He wrote, "... the intelligence here presupposed is a trait more of the character than the brain." He was not talking about smart, shrewd investors with high IQ's. By "character," he was talking

about matters such as independent thinking, discipline, patience, self-control, a desire to learn, etc. It is these characteristics and not brilliance that makes an investor intelligent, and most likely successful.