

Blueprint for Printing Greenbacks

Wouldn't it be great if there were a magic formula for successful investing! Is there a holy grail of investing out there somewhere? We have frequently used Warren Buffett's revealing quote, "Investing is simple, but not easy." If it is so simple, then he only needs to share his simple rules for successful investing so we can follow the roadmap, saving much time and frustration.

In fact, Buffett does share the essence of his "magic formula" with us through his annual shareholder letter plus periodic published articles. Over the years, we have even shared his rules for investing in this newsletter. Excuse any implications of arrogance, but we also believe that investing is simple, that the rules for success can be clearly stated, and that we know those rules. We may not reach the success of Buffett, Templeton, Neff, Lynch and others in the Investor's Hall of Fame, but if we follow our relatively simple rules, we know that, over time, we will be well ahead of the average institutional investor.

We have no concerns about sharing our formula for successful investing with others. Like Buffett, we know that any disciplined formula will soon be incinerated by most investors' market-driven passions. If Buffett

does not worry about others' plagiarizing his basic tenets, then team CornerCap will not worry about others' plagiarizing ours.

We also believe that it is important for our clients to understand the rationale behind the rules and not just blindly accept CornerCap's Good Investing Seal of Approval. With the rapid changes in the investment world, an investor must understand at a very fundamental level why an investment principle works when it works and doesn't when it doesn't.

Below are ten investment disciplines that we believe give CornerCap a permanent advantage over other investors in the equity market. The first four principles focus on return, the last four relate more to risk, and the middle two are equally important cost factors.

Contrarian—In the investment world, the comfort of the consensus offers an enticing and effortless attraction. We believe that investors who follow the mantra of the masses are destined for failure. The investor will end up buying high and selling low, which is a losing proposition even before transaction costs. We have also learned that being able to remove oneself from the sometimes powerfully persuasive behavior of the market is something that must be acquired prior to arrival at CornerCap. This attitude of herd independence must be ingrained in the genes

or developed in early childhood, because it is difficult to instill later in life.

Value—There are a number of different investment styles, and they all work some of the time and none work all of the time. A value-oriented investment approach places more emphasis on the current price relative to current or near-term forecasted fundamentals for a company. While price may be a factor, other styles of investing tend to place greater emphasis on the longer term forecasts, technical indicators, exploiting a narrow market niche, or a myriad of other approaches to investing. With our quantitative research system, we have been tracking many of the above investment disciplines for over a quarter of a century, and the value-based indicators (e.g., low price/earnings, low price/free cash flow, etc.) work more consistently than the others. Also, our corporate personality is better suited for buying bargains than paying an inflated price for some analyst's or economist's pie-in-the-sky forecast.

Quantitative Discipline—Almost every great investor we know, at least all those investors whose success lasted longer than a decade, used some form of quantitative discipline, whether he admits it or not. This gave him a means of (1) funneling down from a long list of prospective investment buying opportunities available to him and (2)

maintaining a list of holdings where the investment characteristics met his personal investment criteria. More importantly, if a quantitative discipline is used with a tilt toward value and contrarianism, the need for “luck” is eliminated. As we have witnessed in numerous market bubbles and explosions, luck can easily carry an investor to success for a five- or ten-year period but not over the tenure of CornerCap’s history. Luck is something we want to have but not to need.

Holdings Bias—Many investors bias the holdings in a portfolio for reasons other than investment fundamentals. These biases create constraints that eliminate or lessen the likelihood of these investors’ holding the optimum portfolio of attractive buy candidates. As much as possible, these restrictive non-fundamental factors should be eliminated. One frequent bias is size, i.e., a preference for holding well known, mega-capitalization stocks. The entity paying the fee, the client, is frequently more comfortable when he sees General Electric in his account rather than Franklin Electric. This real or perceived client preference makes most investment advisors, regardless of the fundamentals, strongly biased toward holding the more comforting name. When a bias such as this is pervasive in the market, it creates a semi-permanent overpricing for the stocks’ meeting those criteria. It will be difficult for these stocks to create the future cash flows

needed to justify the current price. And, avoiding these preferred holdings in our clients’ portfolios gives us a permanent bias toward higher performance. Another bias, especially with the non-institutional client, is geographic. Individuals have a preference for local companies that have been historically successful, regardless of their current pricing or fundamentals.

Actual Costs—In prior writings, we have discussed how much an investment return can be diluted by costs. Wall Street is huge and hungry, and it demands to be fed. Unfortunately, the only cost that is easy to compute and actually see is our management fee. In addition to keeping our fee at or below the market, we also work to keep all the other Wall Street costs minimized. One advantage that CornerCap has over most institutional investors is that our more contrarian and value-based investment approach results in lower portfolio turnover, and this minimizes commissions, market spreads and taxes (for taxable accounts).

Opportunity Costs—The first rule for a winning investment strategy is that you have to be there to win. Everyone, we included, wants to know when the market is going to drop precipitously so he can get out for a while, i.e., sell and go to cash. (However, CornerCap portfolios were up significantly in 2000 and 2001 as the market crashed.) Most

investors feel that some type of market timing strategy is good and can be successful, even though almost all of the investment legends and academic studies have concluded otherwise. More volatile longer term assets, like stocks, bonds and real estate, create higher returns over time than low/no volatility cash. The opportunity costs (lost return) come from (1) holding a lower returning asset, i.e., cash, (2) mistiming the “in’s and out’s” of the market cycles, and (3) actually incurring the costs to transact the “in’s and out’s” of the market, i.e. commissions, spreads, taxes, etc. Like actual costs, opportunity costs dramatically dilute many investors’ long-term returns.

Benchmark Blind—We require specific investment objectives for every CornerCap client. While there are at least one or two benchmark indices that we use to measure our success with the client’s account over the long-term (five- or ten-year period), we maintain a “benchmark blind” posture with the day-to-day management of all of our accounts. Because indices are capitalization weighted, they tend to be anti-contrarian, i.e., the indices move in lock step with the herd on Wall Street. As such, to succeed in the long-term, we must disregard the indices in the near term. Because of pressure from clients and consultants, the current trend is more toward closet indexing than being benchmark blind.

Weightings—We generally put 40 to 50 stocks in each client’s account. Of course, we select these stocks because we are confident that over time our holdings will perform better than the 1,500 stocks that we chose to exclude from the portfolio. However, we do not know which of the stocks in the portfolio will be the four-bagger stars and which will be the ones that will keep us awake at night. Therefore, we always move toward an equal weighting of the stocks in our portfolios. This equal weighting standard also helps us implement our disciplined rebalancing process. When a stock has moved up dramatically in price, we will automatically trim the holding, preferring to assume that there will be some regression back to a longer term average growth rate than a permanent, dramatic acceleration of the trend line. Conversely, when a stock’s price has dropped significantly, we review the fundamentals and, assuming we decide to recommit to the stock for the long term, we will round up the position. This process forces a discipline of buying low and selling high over time.

Qualitative Screen—The Quantitative Discipline presented in number three above is primarily a return-seeking process with little emphasis on risk control. While the design of our quantitative process is based on philosophy and academics, its implementation is more mechanical. Also, we can easily measure the success or failure of our

Quantitative Discipline; did the basket of recommended buys outperform the basket of recommended sells? With the Qualitative Screen, we turn off the computers and begin the very manual process of selecting the specific stocks to be purchased from the relatively short list of buy candidates recommended by the Quantitative Discipline. While all of our processes are return seeking, the methodical de-selection and exclusionary process of the Qualitative Screen results in a heavier dose of risk-control. For example, we may exclude a company because it has too much debt, a weak CEO, an alarming pension obligation, an extraordinary contingency risk with pending litigation, etc. As we lower our risks by eliminating these stocks that show unusually higher risks, we must be sensitive also not to lower our realizable return. Risk and return do work together over time.

Diversification—Using currently available historic data to control risk with our Qualitative Screen is essential. However, as President Dwight Eisenhower once said, “Neither a wise man nor a brave man lies down on the tracks of history to wait for the train of the future to run over him.” We avoided almost all of the major train wrecks in recent years, Enron, Adelphia, AIG, HealthSouth, Tech Bubble, etc., but we know there will eventually be one around some seemingly safe curve. None of us can accurately predict the future. The ultimate

risk control mechanism is diversification. We broadly diversify our portfolios across industries and sectors. Also, when permitted by the client’s objectives, we like to diversify our portfolios across market capitalizations. Our clients’ assets must be available to them in five, ten, twenty years, and no single unforeseen catastrophe can interfere with that overriding objective.