

# Fear's Running Rampant—It's No Time for Reactionary Selling

For Quarter Ending September 30, 2008

Events during September and early October shook financial markets and investors to the core. While we would argue that bank challenges and a broader recession were largely expected, the market has been surprised by the tenacious lock-down in credit markets, as well as the unprecedented decisions by government officials, whose actions and words beg the broader conclusion that we must indeed be in a crisis.

Consider that hallowed names like AIG, Bear Stearns, Fannie Mae, Lehman, Merrill Lynch, and Wachovia have either disappeared or fallen under government control<sup>1</sup> or that the government's historic \$700 billion emergency bailout package has not yet encouraged credit markets to open up (in fairness, initial distributions won't occur for another few weeks). Or further that, on October 8, in an effort to ease the economic impact of the financial crisis, the US Federal Reserve along with five foreign central banks announced an unprecedented globally coordinated interest rate cut of 50 basis points.

Witnessing such emergency intervention, global stock markets went into a freefall. The major US indices were down 21% for just the first nine days of October alone, after a brutal -20% for the first nine months of 2008.

## Putting the Sell-Off in Context of Broader Risk Aversion

While the equity markets are getting the headlines now, they are actually catching up to the recent news of the credit markets. After sliding for over a year, short-duration Treasury yields turned

---

<sup>1</sup> Overall, CornerCap has had very good equity sell decisions in this group, including Washington Mutual (sold in 7/07 at \$42), Fannie Mae (8/07 at \$68), Bear Stearns (2/08 at \$80), and Wachovia (3/08 at \$29), well ahead of their fire-sale bailouts. Nevertheless, in several accounts, we do have targeted allocations to AA-rated bank corporate bonds, including some of these names, which saw weakness during September.

negative briefly in mid-September, implying investors were paying the government for safety. Those yields still sit at some of the lowest levels in decades and demonstrate incredible risk aversion among bondholders. In September, even the "safest" investments came into question. Some money market funds which held AAA-rated bank corporate bonds fell below par value in September as these bonds (AIG, Lehman, Merrill, Citicorp, Goldman, etc.) traded to distressed levels.

People are wondering whether any investment is safe and whether they should just move to cash.

## Our Message

We discuss the current financial crisis in our fall newsletter ("The Long Road to Redemption"), but our message here is:

- Now is generally the wrong time for broad selling. There is already tremendously negative news flowing today. In many sectors, we believe recession started some time ago. Stock markets usually bottom AHEAD of the end of recessions. While it's hard to "call the bottom," you are more likely to be selling stocks nearer their lows than their highs.
- Nevertheless, with extreme risk aversion among lenders and heavy debt loads plaguing bank balance sheets, we still anticipate a difficult year ahead for the economy. It will take time for home prices and debt levels to fall to rational levels, even with the government bailout plan. There are no easy answers.
- In times of fear, we prefer buying stocks selectively, in keeping with our disciplined investment process. We do not pretend to know when sentiment improves, but the goal, as always, should be buying nearer the lows and selling nearer the highs.

# Fear's Running Rampant—It's No Time for Reactionary Selling

For Quarter Ending September 30, 2008

That last point is crucial. Periods of extreme fear generally present long-term investors great opportunity. That doesn't mean landmines don't remain. With a weakening economy and closed credit markets, they probably do. But many good companies are being priced today by broad fear.

The key is finding those companies whose balance sheets and cost structures enable them to weather the current storm and drive solid earnings growth over time. We have confidence that our systematic investment process helps do that effectively, as we discuss below.

## Current Performance and Investment Decisions

As long-term investors, we tend not to focus on short-term quarterly results, as that can allow emotion to creep into a disciplined process. Our approach is to buy stocks that we argue have attractive prospects but are generally out of favor (or even tinged by fear) to improve our probability of outperformance in three to five years. That said, some investors find comfort in a regular, honest scorecard, and the following discussion gives a snapshot of what our proprietary research system is producing currently.

CornerCap's large-cap, equity-only composite was down 9% for the quarter and 19% for the year (versus the S&P 500's -8% and similar -19%). Our small-cap, equity-only composite was down 6% and 8%, respectively. Bank stocks, to which we have limited equity exposure now, actually rallied since July on the government's bailout plans, which helps explain why we lagged the major indices a bit for the quarter. We are comfortable with this short-term event, as we still rank most of the commercial banks as "sells."

Late last year, in keeping with our contrarian mindset, we moved more aggressively toward consumer-oriented stocks, at a time when they were under pressure on fears of a consumer downturn. We remain overweight in this group relative to the S&P 500, with

roughly double exposure on average. After a rough year in 2007, this sector, while down about 15% year to date, has performed better than average.

We also have overweighted materials and industrials stocks for some time. Those have been hit hard on recession fears and are down about 22% year to date through September 30. Certain stocks in these sectors are becoming more attractive according to our research discipline, and we anticipate increasing our exposure in a prudent manner during this downturn.

We did not ride many energy stocks on the way up (we did own a few stocks), and that sector was hit the hardest during the quarter (down 25%) with the drop in oil prices. We have been buying selectively since late spring (perhaps early) and anticipate increasing our exposure selectively in this group.

As we mentioned above, the banking sector rallied off its July lows, from which we derived little benefit since we underweight those stocks. We do have greater exposure to insurance stocks, however, which remain mildly attractive according to our research.

We should point out that our bottom-up research process maintains exposure to most sectors at any one time, since diversity is a key element of risk control. In addition to the above sectors, our clients generally have average exposure in Health Care, Information Technology, and Telecom/Utilities and below average exposure in Consumer Staples (one of the current safe havens for the broader market), relative to the S&P 500.

## Conclusion

We anticipate a challenging period for the economy as the housing bubble deflates, consistent with our thoughts from earlier this spring. At some point, the US economy will return to growth, and the credit

# **Fear's Running Rampant—It's No Time for Reactionary Selling**

For Quarter Ending September 30, 2008

overhang will stabilize. Predicting how this will evolve is challenging and dangerous. Our long-standing clients know that we do not engage in such a guessing game. We therefore remain fully invested, using our proven screening system to buy stocks we believe to be on sale today, with ample cushion to survive a difficult environment. Such an approach allows us to outperform once fear and doubt subside for our selected stocks and sectors. Given the current uncertainty, it is the only way to invest responsibly, in our view.