What Will Happen in 2010?

December 31, 2009

Considering the economic turmoil of the past two years, we were not surprised to see several headlines calling 2009 “a year to forget.” From our own perspective, we were ironically relieved to end up calling it a year to remember, because it highlighted the importance of staying with a proven investment discipline when fear and uncertainty reigned supreme. Our often contrarian investments made in 2007 and 2008 enabled us to achieve well-above average returns for 2009. (See the notes regarding CornerCap’s performance below.)

But there is no time to pause and be proud, for the investment climate continues to shift. The big debate now is whether the nascent economic recovery will hold, or whether the Fed will raise rates sooner rather than later. While fair questions, we feel they are impossible to predict and misleading as a guide for investment decisions.

The better question to us is what happens once the federal government reduces its financial intervention? Our goal is not to predict the near-term outcome, but to stress-test our bottom up investment decisions and asset allocation strategies, to improve the probabilities of longer term success in an uncertain environment.

Government intervention has been massive and frankly distortive to the economy and financial markets. Consider that the US Treasury sold $2.1 trillion in bonds and notes in 2009 to support stimulus spending, bank rescues, and yawing budget deficits. While it helped avoid Armageddon a year ago, it has arguably propped up economic growth (low mortgage rates, budget relief for state governments, artificial stimulus) beyond what is sustainable. Less government intervention would lead to better stability over time, but it could mean further risk to housing prices, deficits, and some balance sheets in the interim.

The Psychology of It All

We do not make these points to predict top-down winners and losers. More important to us are: 1) how investor psychology reacts as these events unfold and 2) how much cushion our investment decisions have if/when these events occur.

One example of increased risk, as we have been describing for some time, is safe-havens like government debt. Prices reached historic highs (or, yields historic lows) in early 2009, offering investors no return unless deflation prevails. No surprise, short duration Treasuries posted -4% returns for 2009. Even now, yields are generally unattractive if rates begin to rise once government intervention ends, or growing deficits further alarm US creditors.

The incredibly low cost of debt has also fueled increased risk acceptance, as has been widely reported. High yield debt posted 69% returns in 2009, debt-laden REITs were up 31%, international equities surged over 30%, and domestic equities (S&P 500) posted 26% gains. For corporate bonds, spreads over Treasuries have now tightened to pre-crisis levels—sometimes even tighter. In our view, the prevalent “risk trade” has arguably run its course, although we cannot predict when it will truly change.

What It Means for Investment Strategy

We are mindful that deflation may persist near-term but that the probability of inflation (or, at minimum, higher rates) increases in four or five years. In fixed income, we therefore typically avoid Treasurys, preferring better yielding instruments like CDs and agency bonds, with nearer-term maturities. Among corporate bonds, we seek to spread risk across issuers and strive for maturities with short-to-medium term durations. For longer term bonds, where inflation poses a risk, we prefer inflation-protected Treasury bonds (“TIPS”). Where appropriate, we have diversified into complementary publicly-traded asset classes through exchange traded funds (“ETFs”).

In domestic equities, we paid careful attention to our “sell signals” during 2009. During the darkest days, we avoided selling when possible and often sought opportunities to “round up” on beaten-down stocks our research found to be attractive. The strong rally in equities often favored the credit-challenged stocks, several of which we owned. We actively trimmed positions in these and other outperformers during the rally, or even sold positions completely in favor of more contrarian ideas.

Over the past year, corporate balance sheets have generally improved, and many companies we see in our research have large cash balances. Moreover, corporate profits are improving on cost cutting and better productivity. Given the uncertain economic outlook, we continue to put special emphasis on new buys that have underperformed but have ample cushion—i.e., solid cash positions, good free cash flow, favorable margin trends, and manageable debt loads. We also seek stocks which add diversification to what helped us outperform in 2009.

Adhering to a bearish or bullish prediction on the economy or markets misses the inevitable opportunities and risks that are unfolding in unpredictable ways, and leads to "market timing," with its dismal record. Our disciplined research and rebalancing continues to balance risk/reward with fundamentals and probable outcomes to help our clients meet their long term financial objectives in an uncertain time.

CornerCap Performance

CornerCap Investment Counsel, Inc. (the "Company") is an equity investment management firm whose objectives include Small-Capitalization, Small/Mid-Capitalization, Mid-Capitalization, Large/Mid-Capitalization and "WRAP" accounts. CornerCap specializes in investment approaches that either focus purely on quantitative factors or include a combination of quantitative factors and qualitative analysis.

Past performance is no guarantee of future results, and all investments are subject to risk of loss.

Performance is presented in US dollars.

The following two (2) tables show composite returns for two (2) strategies offered by CornerCap. These returns do not represent the results of any single client.

Small-Capitalization Equity Composite

As of December 31, 2009
Returns for periods over 1 year are average annual returns.

Periodic Returns	3 Month	Year to Date	1-year	3-year	5-year	10-year
Composite Gross	4.30%	42.55%	42.55%	-4.51%	-0.49%	7.82%
Composite Net	4.06%	41.45%	41.45%	-5.30%	-1.32%	6.96%
Vs. Benchmarks						
Russell 2000 Index	3.87%	27.17%	27.17%	-6.07%	0.51%	3.51%
Russell 2000 Value Index	3.63%	20.58%	20.58%	-8.22%	-0.01%	8.27%

Large/Mid-Capitalization Equity Composite

As of December 31, 2009
Returns for periods over 1 year are average annual returns.

Periodic Returns	3 Month	Year to Date	1-year	3-year	5-year	10-year
Composite Gross	7.00%	39.62%	39.62%	-4.05%	1.87%	5.45%
Composite Net	6.76%	38.45%	38.45%	-4.87%	1.00%	4.54%
vs. Benchmarks						
S&P 500 Index	6.04%	26.46%	26.46%	-5.63%	0.42%	-0.95%
Russell 1000 Index	6.07%	28.43%	28.43%	-5.36%	0.79%	-0.49%

The Russell 3000 Index measures the performance of the 3,000 largest U.S. companies (based on total market capitalization), which represent approximately 98% of the investable U.S. equity market.

The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 2000 Value Index measures those companies of the Russell 2000 Index that have lower price-to-book ratios and lower forecasted growth values.

The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index. The Russell 1000 Value Index measures those companies of the Russell 1000 Index that have lower price-to-book ratios and lower forecasted growth values.

The S&P 500 Index measures the performance of the 500 largest U.S. companies (based on total market capitalization).

CornerCap Investment Counsel, Inc., claims compliance with Global Investment Performance Standards (GIPS®)

For a complete list and descriptions of CornerCap's composites, please send a request to info@cornercap.com.