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CORNERCAP® INVESTOR

From Wall Street to Peachtree Street

Why These "Streets" Are Inherently and Fundamentally at Odds

Last June, Cannon Carr left his senior equity analyst position at a major Wall Street firm in New York to join Atlanta-based CornerCap Investment Counsel on Peachtree Street, where he had been a client for over eight years. During that period, he advanced through the ranks of Wall Street, providing institutional investors with in-depth sector research and investment recommendations. In this article, Cannon presents his thoughts on these two conflicting "streets" using the tech bubble as a prism, and explains why they are inherently and fundamentally at odds.

During the tech/telecom bubble, two investing worlds were colliding in rare form, with "winner takes all" consequences. Uniquely, I had a stake in both. Witnessing the ensuing battle would cement my commitment to CornerCap and lead me to join as a shareholder and employee in 2007.

In one world ("Wall Street," comprising both the brokers and many institutional money managers), my role as an equity analyst covering emerging telecom stocks put me at the epicenter of the New Economy. Analysts approached the status of rock stars. To say it was a time of incredible bullishness is an understatement.

In the other world ("Peachtree Street"), I was a client of CornerCap, which purposefully shunned stocks like those in telecom. Value investors were anything BUT rock stars. There was no irrational exuberance in the Halls of Value.

My early client discussions with CornerCap revealed a crucial insight: these two worlds were irreconcilable, with mutually different keys to success. Moreover, they highlighted that periods like the tech bubble on Wall Street were unsustainable and dangerous. The era would probably have an ugly ending, but you couldn't predict when.

I'll leave the details of my Wall Street work to some representative quotes *(see page 2)*, but it is clear to me that much of my success stemmed from what CornerCap and several close mentors at the time taught me: think independently, maintain a consistent point of view, and ground conclusions in financial fundamentals.

What impressed me most about CornerCap during that time was its unwavering investment discipline, time-tested for over 20 years. Its independence and objectivity presented an alternative to the emotional and reactionary world of Wall Street. It also successfully steered my family through the financially destructive bubble, helping us avoid the pain that many of my Wall Street peers ultimately experienced.

So, it is a privilege for me to join CornerCap and its team of seasoned investors. CornerCap was founded on a healthy skepticism of Wall Street behavior, which serves as the underpinning of its contrarian philosophy.

Why the need for skepticism of Wall Street behavior?

Short-Term Incentives. The economics of Wall Street

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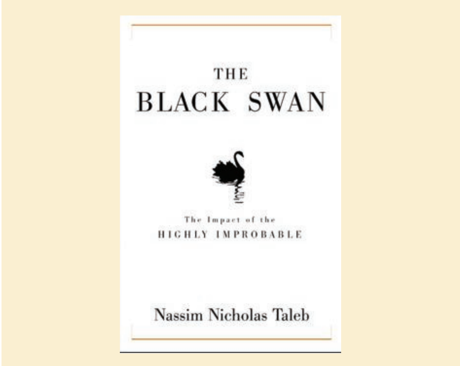
Black Swans and Investment Management

Our View on Taleb's Recent Best-Selling Book



The recent best seller, *The Black Swan: The Impact of the Highly Improbable*, introduces a fascinating concept, with important lessons for investment management.

As the publisher's synopsis states, "A black swan is a highly improbable event with three principal characteristics: It is unpredictable; it carries a massive impact; and, after the fact, we concoct an explanation that makes it appear less random, and more predictable, than it was. The astonishing success of Google was a black swan; so was 9/11."

The title refers to the fact that, before the discovery of the Australian Black Swan, everyone assumed all swans were white. A Black Swan, in a single sighting, can invalidate a widely maintained belief.

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breed short-term thinking. The investment horizon for the average "long-term investor" has shrunk over the past decade. Most have a six-month commitment, at best. Much of this stems from the surge in hedge funds. Competition for "alpha" (or, outperformance) is so fierce that a stock return must occur relatively quickly; a manager can't afford to "wait it out."

Moreover, since hedge funds account for the substantial majority of trading commissions, brokers must constantly generate ideas for this hungry group. Analysts must make "actionable calls" with greater frequency, which generate trades but can sacrifice accuracy and swell hype.

In our view, such behavior creates noise in the market, leading to opportunity for disciplined investors.

Myopic Reactions. Induced or seduced into a short-term mentality, the Wall Street herd often fixates on one or two issues, ultimately missing important nuances and ideas altogether. Ironically, this reaction initiates a self-fulfilling cycle at first as mass behavior drives stock performance, yielding overly bullish or bearish swings. The volatility is very difficult to predict. Emotional reactions invariably lead to pain for the emotionally charged and opportunity for those who maintain a reasoned perspective.

Interestingly, amidst this volatility, we know several hedge-fund veterans who lament that there are too many investors chasing too few ideas. Outperformance may occur one year, but it is difficult to sustain year over year. Thirst for short-term results can encourage managers to make highly aggressive bets, with significant downside risk.

Herd Mediocrity. It is easy to be a mediocre analyst or investor. In fact, the "system" encourages it. On average, following the herd is safer, since taking a controversial stand could make you blatantly wrong. But, herd mentality by definition means you simply track the group, which tends to perform relatively poorly. CornerCap's answer is to pursue ideas following the principle of "regression to the mean." In practical terms, this simply means that we will be absent from those Wall Street occasions of severe overreactions and present for those inevitable regressions back to reality.

"Don't Know When to Sell." Sell-side analyst research typically lacks a "sell" discipline. An analyst can develop emotional ties to a stock or management team, making it more likely that price targets are revised upward rather than stocks downgraded. In our view, the sell decision is one of the hardest decisions in investing, but one of the most important.

The Focus is Marketing. Wall Street research is primarily a marketing game and does not reward stock picking success. Strong relationships with management, or brokering a meeting with influential industry veterans, generally receive greater recognition from institutional investors. Despite recent reforms, an inherent conflict of interest persists, in our view—i.e., you can't curry favor with management and be negative on a stock. CornerCap prefers to ignore the recommendations from Wall Street analysts.

Conflicted Sources of Information. We continue to hear analysts parrot what senior management says. CEOs are really sales people, selling their company vision and value. They can explain how things work, but they are not objective sources. Instead, audited income statements combined with balance sheets tell the true story (an income statement alone can be misleading). If financial statements are accurate, the numbers over time don't lie.

Looking at these two "streets," we realize that it pays to be "street smart." Relying on Wall Street as steward of your financial security can be fraught with risk and peril. Independence, objectivity, and a disciplined buy/sell process present a necessary alternative to the market's emotional and reactionary decisions. Walking the two streets as both client and analyst helped me appreciate the value CornerCap brings.

Quotes of Note From a Decade on Wall Street

"We won't be having a funding crisis anytime soon."
— CEO's public response to my downgrade that morning, about nine months before declaring bankruptcy.

"But that's the opposite of what Grubman is saying!"
— Institutional investor wrestling with my cautious outlook versus the #1 ranked telecom analyst's hyped-up stance.

"Internet traffic is doubling every 100 days."
— An industry mantra during the bubble. Never proven. Ironically, it helped justify a mega-wave of financing for over a hundred emerging telecom providers, most of which disappeared.

"If you tell me to buy it, I will."
— Analyst of a large fund manager during 2000, showing me a dangerous deference to Wall Street.

"Your conclusion must be right … you've never been wrong!"
— Institutional salesman the morning of my negative call on Nextel in 2002. I ended up being wrong.

"You can't do that to the employees of this company!!!"
— COO, shouting at me the morning I cut my price target on his stock in half. Company ended up barely avoiding bankruptcy.

"Just buy it and hold it. Akamai is reinventing the sector."
— Suggestion to me from a telecom analyst during the bubble. AKAM peaked at $345 per share before falling below $1 in 2002. It is now around $30.

"Net2Phone trades at high multiples, but so does its comparable peers."
— Common refrain for tech/telecom stocks.

"Guess you look pretty stupid now!"
— Retail broker, berating me early in my career for following management's rosy (but unrealistic) forecast (which the company missed).

The Black Swan, continued from page 1

Conventional Wisdom

The book points out that every society's prevailing thinking is usually the result of its people's assuming that future events must be a linear extension of the past. Society assumes that everything follows a bell curve whereby extreme events are so rare as to be irrelevant.

As the book explains, most risk management strategies fail at the worst possible time because they are based on bell-curve assumptions. "Black Swan" events are rare and totally unpredictable. We never see them coming, but we can later explain why they should have been obvious.

> We manage our clients' assets by acknowledging the reality that Black Swans exist and will show themselves again, probably when it is least expected.

Implications

As Legg Mason's Michael Mauboussin recently showed, Black Swans have a dramatic impact in the investment world. Consider that, for the daily price changes in the S&P 500 for the past 30 years or so (over 7,300 observations), the compounded annual return, excluding dividends, was 9.5%. But, if you remove the 50 worst days (less than 0.7% of the sample), the returns soar to 23.5%. Missing the 50 best days compresses the return to less than 1% ("Mauboussin on Strategy" 5/23/07). Those are Black Swans!

How Does CornerCap Think About Black Swans?

We believe no one can predict the future. So we don't waste time listening to those who say they can or are trying to do it themselves. If you listen to forecasters, you will overpay for over-promises and you will be disappointed.

We counsel against "timing the market"—i.e., trying to determine when to "be in cash" and when to be "fully invested." Sadly, most people will be turned off by our message that we can't foretell the future, because most people DEMAND that someone reassures them about the future and promises to protect them from it, if it's negative.

We manage our clients' assets by acknowledging the reality that Black Swans exist and will show themselves again, probably when it is least expected. Our client relationships are built with people who accept the limitations of the market and of all investment advisors. They understand that most important future events are unknowable and that we need to invest with this in mind.

Another Black Swan is the Thanksgiving turkey, and many investors seem to follow a similar pattern. They have a wealth of daily experiences gobbling up regular feedings from the market, and then one dark day in November, what seems normal becomes terminable.

Rather than following the flock to their daily feeding, at CornerCap we are always aware of and working to manage any potential worst case scenario.

CornerCap Continues Ties With Shakespeare

CornerCap is in its ninth year as a sponsor of Georgia Shakespeare. Like last year, CornerCap is sponsoring the summer festival, including three of Shakespeare's most attractive, audience-gathering plays. The program will be exciting! Please join us for the performances at Oglethorpe University's Conant Performing Arts Center in Atlanta. For more information call (404) 264-0020 or go to www.gashakespeare.org.

Georgia Shakespeare's 2008 Season includes:

As You Like It

June 11 – August 1
This gender-bending comedy full of mistaken identities, a cross-dressing heroine, and endearing buffoons will take you on a romantic romp through the Forest of Arden.

The Merchant of Venice

June 26 – August 2
Love, money and religion are put on trial in Shakespeare's courtroom drama as Shylock demands "a pound of flesh" from the well-known merchant.

All's Well That Ends Well

July 10 – August 3
A charming account of one woman's wits and schemes to win the heart of a reluctant lover. Watch and see if all really does "end well."

Park Krausen and Chris Ensweiler in Georgia Shakespeare's 2007 Production of The Servant of Two Masters

CornerCap Investment Counsel
Sponsor of
Georgia Shakespeare's
2007 Summer Festival

GEORGIA SHAKESPEARE

Join CornerCap at one of the Georgia Shakespeare performances in Atlanta this summer.

In This Issue:

(From left) In our Atlanta conference room, staff members from CornerCap recently met with Georgia Shakespeare: Kevin McGonigle; Stacey Lucas, development director; Tom Quinn; Allen O'Reilly, education director and associate artist; Richard Garner, producing artistic director and cofounder; Cannon Carr; and Sarah Robinson, development manager.

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