Jolley Asset Management
Investment Update

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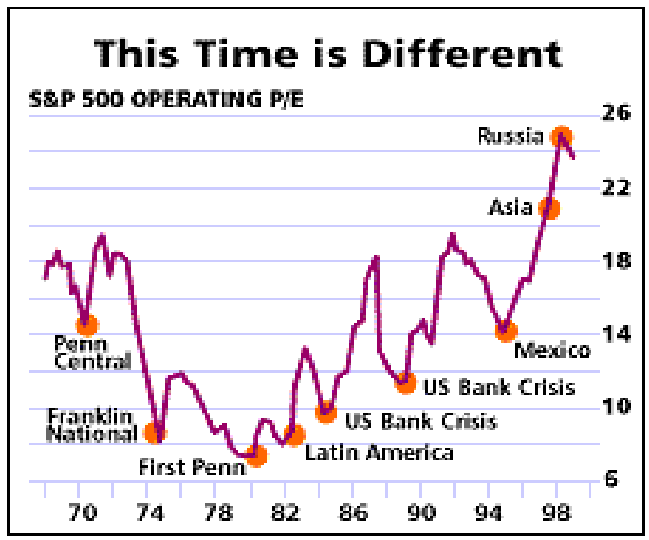
"The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long term values."

Warren Buffett August 6, 1979

As many of you already know, I have recently left my position as Chief Investment Officer of Centura Bank to fullfill one of my lifetime goals, to start my own investment advisory business. So much for my market timing! However, perhaps there is a silver lining in all of this madness. As Warren Buffett" stated in his 1997 Annual Report "*if you expect to be a net saver during the next five years, should you hope for a higher or lower stock market during the period? Many investors get this one wrong. Even though they are going to be net buyers of stocks for many years to come, they are elated when stock prices rise and depressed when they fall. In effect, they rejoice because prices have risen for the "hamburgers' they will soon be buying. This reaction makes no sense. Only those who will be sellers of equities in the near future should be happy at seeing stock prices rise. Prospective purchasers should much prefer sinking prices."*

For months now, I have been expressing my concern about the valuation levels in the domestic equity markets. Don't worry the experts said, as long as money flows into 401-K funds and the baby-boomers continue to buy, the markets cannot fall for any extended period of time. The demographic forces made it "different this time". Well so much for "it's different this time". The only real difference was that this time the valuation levels of the market and especially the "nifty fifty" was sky high.



Source: ISI Group

Correction or Bear Market?

As of September 1, 1998 the Dow Jones Industrial Average and the S&P 500 were down approximately 19% from their highs for the year, while the Russell 2000 (small company index) was down approximately 31% from its all time highs. Most consider a decline of greater than 20% a bear market, while anything less than that is merely a correction. Call it a correction or call it a bear market, but either way there has been considerable pain for the average investor. Many of the small and mid-capitalization companies have already experienced bear market declines, while the large S&P 500 companies have fared better, as there has been a "flight to quality" coupled with a surge in indexing. In the most recent market meltdown, however, many of the large S&P 500

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names or “nifty-fifty” type of stocks absorbed the most punishment. We continue to believe that many of the large S&P 500 names that have been bullet-proof for so long, are now the most over-valued. While many feel safe in the “household names”, many of these stocks continue to trade at nose-bleed multiples while the small and mid cap names are at much more reasonable valuation levels. We would focus on buying those companies where the “bad news” is already reflected in the stock price, rather than those that must meet or exceed expectations or face the prospect of a large percentage price decline.

Earlier in the year, most analysts were projecting S&P earnings increases in the 10-12% range. Now many are expecting increases of only 3% or so. We have likely entered into an environment where there will be a multi-year period of declining earnings growth expectations. Stocks are likely to enter a similar environment where investor expectations become tempered somewhat. Returns in the coming years are more likely to be in line with long term historical trends, rather than the 25% returns that many have become accustomed to.

We can blame all of the current problems in the equity market on Asia, Russia, Clinton, currency de-valuations or the like; however, the biggest problem that currently exists is valuation levels. At the peak on the S&P 500 index, stocks were trading at over 28 times trailing earnings and a dividend yield of only 1.5%. The recent pullback has brought many companies price/earnings multiples back within reason creating a better buying opportunity. In addition, going forward the only way domestic companies will be able to grow revenues and earnings will be through consolidaton. We believe the patient value investor will be rewarded though this activity as many undervalued companies become acquistion targets. For example, in the last month, Betz Dearborn and AMP have received cash acquistion offers at huge premiums to their then current stock prices. We believe this trend will accelerate, fueled by the low cost of money and lack of top line growth opportunities for corporate America.

The Federal Reserve board is likely watching the current global situation very closely. It now appears highly probable that the Fed will be forced to ease credit and become the source of liquidity as the world battles financial instability. Greenspan can now forget about the “irrational exuberance” that was so prevalent in the equity markets over the past couple of years. Commodity price pressures are non-existent; deflation is now a much larger concern of the Fed officials. The odds of a Fed easing has increased dramatically, which would provide for lower rates on the short end of the yield curve. The long 30 year U. S. Treasury bond closed on August 31, 1998 with a yield of just under 5.3%

How Far Is Down?

Total return on Standard & Poor's 500-stock index during post-World War II bear markets.

June-November 1946	-21.8%
January-June 1962	-22.3%
December 1968-June 1970	-29.3%
January 1973-September 1974	-42.6%
September-November 1987	-29.5%

Source: Ibbotson Associates

The above chart gives one some idea what the average post World War II bear market has looked like. If history serves as any guide, it is probably safe to say that the worst is probably behind us at this point. It might be a little early to get extremely aggressive, however, it seems fair to say it is too late to become an aggressive seller in here. We think it will be a market where active management will have a much easier time versus the averages than any time over the past few years. We do not believe that buying the market indexes will be a successful strategy over the next few quarters. Stock selection and the assessment of risk versus reward will once again become very important. Its back to basics and Jolley Asset Management would love to talk with you about your personal financial goals and objectives. Please feel free to call with any comments, concerns or suggestions.

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President and Chief Investment Officer