Jolley Asset Management Investment Outlook

Volume 1, Issue 6 Fall 1999

"There's such an overvaluation of tech stocks it's absurd, and I'd put our company's stock in that category."

9/23/99 Steve Ballmer—Microsoft President

As the millenium draws to a close, it also appears that the bull market of the 90's has finally run its course. While Wall Street experts have officially labeled the recent downturn a "correction", we believe that far more damage has been done to the broad market than most realize. According to Ned Davis Research, the average stock has fallen nearly 20 % since April 1998. Furthermore, according to Ned Davis, only 24% of stocks, from a universe of 7700, are above their April 1998 peak. A "stealth bear-market" might be an appropriate name for the recent market action, but this is clearly not your typical bull market. The chart shown below gives a clearer picture of what has been transpiring in the equity markets in 1999.

TABLE 1

Index	3rd Quarter 1999	YTD 9/30/99
DJIA	-5.4%	13.9%
S&P 500	-6.2%	5.4%
S&P 500(Eq Wt)	-10.9%	-1.0%
S&P Mid Cap	-8.4%	-2.1%
Russell 2000	-6.6%	1.3%
Value Line	-10.3%	-4.4%

Benjamin Graham, in "The Intelligent Investor," wrote, "Nearly all the bull markets end with a number of well-defined characteristics in common, such as 1) a historically high price level, 2) high price/earnings ratios, 3) low dividend yields as against bond yields 4) much speculation on margin, and 5) many offerings of new common-stock issues of poor quality. The current market as measured by the S&P 500 had all of these characteristics. Currently the S&P 500 trades at 1) over 31 times trailing earnings, 2) over 6x book value and 3) with a dividend yield of just over 1%. The frenzied new issue market (primarily internet and technology related) and the surge in speculative day-trading by individuals has seen no peers in this writer's opinion. All of the signs are there indicating that this bull market has finally run its course.

On numerous occasions, we have examined the S&P 500 Index and its bias towards large-cap growth stocks. This has enabled the S&P 500 to continue to outperform the small and mid-cap indexes over the first three quarters of 1999. Comparing the performance on the S&P 500 benchmark index with the Value Line Index and S&P 500 (equal weighted) index (see Table 1) shows significant performance divergences. This is largely due to the fact that the S&P 500 is market capitalization weighted and its performance is dominated by the top 50 companies. This, coupled with the fact that technology companies currently comprise 25% of the index, can largely explain the S&P being up while the average stock has declined approximately 20%. According to Dorsey Wright & Associates, as of 9/30/99 only 33.9% of stocks on the NYSE are actually up for the year. The "nifty-fifty" which is dominated by large technology companies such as Lucent, Dell, Cisco Systems, Microsoft, America Online and Intel has really been the only game in town.

The problem with the technology sector is clearly one of valuations. Lucent, Dell, Cisco Systems, Microsoft, America Online and Intel carry trailing price/earnings ratios between 36 and 177 times. Microsoft President, Steve Ballmer, recently stated "There's such an overvaluation of tech stocks it's absurd…..and I would put our stock in that category." Ballmer went on to say that the media contributes to the problem by portraying the industry in terms of a "gold rush." Since 1990, technology has increased from 7% of the S&P 500 index to 25% today. Ed McKelvey of Goldman Sachs recently pointed out that technology has provided 8% of the growth posted by our economy since the start of the decade and that number may well be approaching 11% of the economic growth currently. Mr. McKelvey's work also attempts to derive what percent of the GDP was currently accounted for by technology. His conclusion was that

JOLLEY ASSET MANAGEMENT LLC

111 Candlewood Road, Suite B
P.O. Box 7967
Rocky Mount, NC 27804

(252) 451-1450 Toll Free (877) 4-JOLLEY
E-Mail: fjolley@jolleyasset.com

technology accounts for 5% of GDP compared with 3.6% for the auto industry and 4.5% for the housing industry. While clearly it is difficult to define just what technology is, the fact that Mr. McKelvey estimates it accounts for 5% of GDP is surprising given its 25% weighting in the S&P 500 index. Needless to say, it surely adds credence to Mr. Ballmer's comments about tech overvaluation. While we would agree that the growth characteristics of technology should lead to premium valuations in the market, we would also like to remind our clients that technology is cyclical, rapidly changing and extremely volatile. In summary, we do not believe that the technology sector offers value in today's market, despite excellent long-term growth prospects. We believe that successful long term investing requires one to differentiate between a great company and a great stock.

Coca-Cola is the perfect example of a great company that due to overvaluation was not a great stock. If one would go back two years ago, Wall Street was convinced that Coca-Cola could grow at 18% annually forever. Every portfolio should own Coca-Cola stock due to its predictable earnings growth and dominant market position globally. As it turned out, Coca-Cola was not immune to economic cycles and weakness in the Asian economies resulted in earnings disappointments. As of 9/30/99, Coca-Cola's stock closed at $48.25 down over 45% from the July 1998 peak of $89. Valuations do matter.

While we have not painted a rosy equity market scenario, we remain committed to equities because over the long term one of the greatest risks to your net worth is not owning stocks. We believe that market timing is a futile exercise, and one where it is impossible to succeed. Although inflation is currently low, it can act as a tax, eroding your net worth and purchasing power over time. Owning common stocks is one of the few investment vehicles that can provide a hedge against such a tax. We believe that our value approach will serve us well in any extended downturn for the following reasons. 1) We are disciplined and follow a set of rules to try to eliminate a permanent loss of capital. We do not invest in fads or fad stocks, because once the bubble is burst many times these companies go out of business or do not go back up. 2) We diversify equity portfolios so that no one position typically comprises more than 3-3.5% of the total portfolio. This prevents poor judgement on any one security from impairing the overall portfolio. 3) Our portfolios are characterized by below average price/earnings, price/sales and price/book ratios when compared to the market. 4) Our equity portfolios typically have dividend yields above that of the overall market. We believe that over the long term dividends do matter.

Two issues that we have been purchasing include:

SCANA (SCG)--$24.1875 NYSE (09/30/99)

SCANA, an electric utility based in Columbia, S. C. has declined approximately 35% from its 52-week high. This was largely due to the back up in interest rates and the proposed acquisition of Public Service of North Carolina. Upon announcing the proposed acquisition, SCG reduced the dividend rate from $1.54 to $1.10. Based on the $1.10 indicated rate the stock yields 4.6% versus just over 1% for the S&P 500. What attracts us to SCG is the fact that they own various telecommunication assets (Powertel, and ITC DeltaCom) that currently have a market value of over $10 per SCG share that we believe is not appropriately reflected in the stock price. Placing a multiple of 11x on the 2000 estimate of $1.95 per share and realization of the telco assets would result in a stock price over $31.This coupled with the fact that the utility industry is rapidly consolidating make SCG an attractive holding.

Flowers Ind. (FLO)--$13.5625 NYSE (09/30/99)

Flowers is the nation's leading producer and marketer of a full line of fresh and frozen branded baked foods. The company has three strategic businesses: Keebler Foods (55% owned), Mrs. Smith's Bakeries and Flowers Bakeries. Problems at Mrs. Smith's new facility in Oklahoma and promotional issues have resulted in earnings disappointments at FLO for the past two quarters. Trends at the Keebler and FLO bakery units remain robust and on target, however the shortfall at Mrs. Smiths unit (only 15% of sales) has resulted in the stock falling over 45% from its 52 week high. We are attracted to FLO because the 55% stake in Keebler (KBL-NYSE) is worth approximately $14 per Flowers share. When adjusted for Flowers stand alone debt, FLO trades at an Enterprise Value/EBITDA multiple of 3 times vs. 6 times for the baking industry. FLO yields 3.8% versus 1% for the S&P 500.

****

The yield on the benchmark 30-year Treasury bond has climbed from 5.08% to 6.04% this year resulting in a total return on the thirty-year treasury of a negative 9.2%. While this has been one of the worst performances on the long dated treasury since 1927, our short duration strategy has served our clients well. We continue to believe the short to intermediate maturities offer value in light of the tame inflation data. We also believe that bonds will have to show some improvement before any meaningful rally in equities could occur. One of the benefits of the technology boom and the internet is the fact that it is allowing companies to reduce their cost of doing business. Technology is actually having a deflationary impact on the economy. While higher energy prices and low unemployment are positively correlated with higher inflation, we believe that it will be offset by the deflationary impact and productivity improvements offered by technological innovation.

Frank G. Jolley, CFA