# Jolley Asset Management
# Investment Outlook

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*"There is nothing so dangerous as the pursuit of a rational investment policy in an irrational world."*
*John Maynard Keynes*

While the Dow Jones Industrial Average briefly closed above 10,000 during the first quarter, it does not accurately reflect what is going on in the domestic equity markets. Through March 24, 1999 stocks on the New York Stock Exchange were down, on average, 33.4% off of their highs reached in 1998. On the NASDAQ over the counter market, the average stock had declined 41.8% off of its highs. The fact that the average stock in the S&P 500 has declined by roughly 23% from its high (as of March 24, 1999), doesn't seem like the kind of price action that one would expect during a rip-roaring bull market. Well just what is going on?

To better understand the divergent price trends it is imperative to understand that the S&P 500 index and the Dow Jones Industrial Index are market capitalization weighted indexes. For example, in the S&P 500 index the top five stocks in the index (lets call them the "Nifty Five", composed of Microsoft, General Electric, Wal-Mart, Merck and Intel) together have more impact than the bottom 300 stocks in the index combined. For the last couple of years, the "Nifty-Five" has had an incredible run as more and more investors have taken a "passive versus active" approach to investing. The S&P 500 is no longer a broadly diversified index, but rather one that is concentrated very heavily in a few large companies. See Table 1 for a complete breakdown on the S&P 500 composition.

**Table 1-S&P 500 Composition**

| | |
|---|---|
| Top 100 Stocks | 72.1% of total weight |
| Second 100 Stocks | 14.8% of total weight |
| Third 100 Stocks | 7.4% of total weight |
| Fourth 100 Stocks | 4.2% of total weight |
| Bottom 100 Stocks | 1.5% of total weight |

While I will be the first to acknowledge that many of these meg-caps are great companies with dominant franchises; I would also like to point out that the valuations of many of these companies have escalated to a level that I feel uncomfortable with. This is supported by the fact that since 1990, the S&P 500 has seen market prices rise by some 17.9% annually, while earnings per share and book value have compounded at rates of 7.3% and 2.6% respectively. The "Nifty-Five", which is comprised of Microsoft, General Electric, Wal-Mart, Merck and Intel, currently have an average price/earnings ratio (trailing 12 months) of over 47 times earnings. In summary, many of these companiess stock prices have outpaced increases in their underlying corporate values.

Warren Buffett, in his most recent letter to Berkshire Hathaway shareholders expressed concern not only about valuations, but also about the quality of earnings being reported by corporate America. Buffett blasted corporate managements that he believes have inappropriately used restructuring (usually associated with the acquisition of another company) charges to boost future earnings. In 1998 alone, special charges totaled some $72 billion or close to 22% of total S&P 500 earnings. According to Mr. Buffett, many times "a large chunk of costs that should be properly attributed to a number of years is dumped into a single quarter, typically one already fated to disappoint investors". Buffett goes on "the size and timing of these charges is dictated by the cynical proposition that Wall Street will not mind if earnings fall short by $5 per share in a given quarter, just as long as this deficiency ensures that quarterly earnings in the future will consistently exceed expectations by five cents per share." In his shareholder letter, Buffett also

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argues that existing accounting policies ignore the costs of stock options when earnings are being calculated, even though options are a huge and increasing expense item at a large number of corporations. Mr. Buffett pointed out that when earnings are adjusted for the outstanding stock options, earnings might be as much as 5%-10% lower than the reported number. Some companies are attempting to finance the costs of issuing options to employees by selling "put options" to investment banks. A recent article in "*Forbes Magazine*" concluded that in the past three years, Dell Computer has made more than $3.1 billion in option transactions. In the third quarter of 1998, Microsoft Corporation made an estimated $225 million from the sale of puts alone. While these activities are perfectly legal, the result is an inflated bottom line and one that is not accurately reflecting the profitability of the business enterprise.

What is most ironic is that despite these warnings about the mega-cap stocks and the quality of corporate earnings, there are countless opportunities in common stocks today. Many small and mid-capitalization companies are trading at very attractive valuation levels. The Value Line Geometric Index (equally weighted index comprised of 1700 companies) is currently trading with a median price earnings ratio of 16.5 times versus 32.5 times for the S&P 500 index (the average price earnings ratio for the S&P 500 is approximately 39.4 times earnings). As we discussed in the first paragraph of this letter, most stocks are down significantly from their highs, thus creating some excellent investment opportunities to those with two to three year time horizons. The chart below shows just how divergent returns have been over the past quarter and year.

| | First Quarter 1999 | Yr ended 3/31/99 |
|---|---|---|
| DJIA | 7.0% | 13.2% |
| S&P 500 | 5.0% | 18.5% |
| S&P Mid Cap | -6.4% | .5% |
| Value Line | -6.4% | -17.5% |
| Russell 2000 | -5.8% | -17.3% |

As discussed earlier, the returns on the S&P 500 and Dow Jones Industrial Index have been impacted greatly by the weightings of the large mega-cap names. As a value manager, we are typically migrating down in size to find value in today's equity markets. A couple of equities that we currently find attractive and the investment rationale for each follows:

**Ruddick Corporation NYSE $17.4375 (4/8/99)**

Ruddick Corporation is the holding company for the regional supermarket chain Harris Teeter, Inc. and industrial thread manufacturer American & Efird. Harris Teeter contributes 86% of total sales and operates 144 stores in the Carolinas, Virginia, Georgia, Tennessee and Florida. American & Efird (A&E) is the second largest global manufacturer of thread products. While this may seem to be an odd combination, thread and groceries; it has actually worked quite well as Ruddick has used the free cash flow generated by the thread operations to fund the growth experienced at Harris Teeter. What attracts us to Ruddick is the fact that on a stand-alone basis, we believe Harris Teeter is worth approximately $23 per share alone, when compared to comparables in the grocery industry. With the stock at approximately $17.5, the market is placing a negative value of $5.50 per share to the A&E operation, which is actually doing quite well in a difficult global environment. We expect Ruddick to make approximately $1.03 per share in the fiscal year ended 9/99, implying a price earnings ratio of just over 17x. We believe that Harris Teeter would be an attractive acquisition target in a rapidly consolidating grocery industry. Ruddick yields approximately 1.9%.

**Trigon Healthcare Inc. NYSE $30.1875 (4/8/99)**

Trigon Healthcare is the largest healthcare insurer in Virginia, providing a complete HMO, PPO and indemnity product line under the trusted Blue Cross and Blue Shield trade names. Trigon has met or exceeded investor expectations for each quarter since becoming a public company and boosts an exceptionally strong balance sheet. The company is currently over-capitalized with over $1.45 billion in cash and securities net of debt (9/30/98). Management has estimated that over $500 million of the cash is "free cash" and we would anticipate the company to implement their 10% buyback (4.23 million shares) as soon as the company finalizes its long pending settlement with the IRS. It is anticipated that any share repurchase would be accretive to earnings per share. Current estimates for the year ending 12/31/99 is $1.96 per share so the stock is trading at just over 15 times earnings. More importantly, when the stock price is adjusted for cash (and back out the associated interest income) Trigon shares trade for approximately 13 times earnings. Trigon's book value per share is approximately $24.50, implying a price/book value ratio of just over 1.25 times. The S&P 500 trades at close to seven times book value.

In summary, while we remain concerned about the valuation levels of the "nifty-five' and the "nifty-fifty", we believe opportunities are numerous in the current market environment. We will continue our rational investment policy of buying companies that are priced at significant discount to their estimated intrinsic value, with the hope and expectation that over a reasonable time period the discount will narrow or disappear. *Frank G. Jolley, CFA*

*Jolley Asset Management will be moving to 111 Candlewood Road, Suite B, on or about May 15, 1999. Please drop by and see our new offices.*