Jolley Asset Management
Investment Outlook

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“Many shall be restored that are now fallen, and many shall fall that now are in honor.”
Homer

This past spring numerous newspapers and financial periodicals declared "value investing" to be "out of favor" and dead. The very essence of the articles was that in the "new paradigm," investors no longer cared about value. Large capitalization growth stocks were hot, as were indexing strategies (basically a large capitalization growth strategy due to S&P 500 composition). Money was flowing into the "nifty-fifty" at the expense of massive liquidations in small and mid-capitalization stocks, particularly those of the "value" variety. Too often in investing thinking becomes subordinated to trend following. The public was mindlessly buying stocks because of other investors' earlier successes. In many ways, the mania became a self-fulfilling prophecy as more and more participants jumped aboard the same stocks, pushing many of the valuations to "excessive" levels.

To say that value is out of favor is not only contradictory, but also shows a complete misunderstanding of the definition of value. By its very definition, value stocks are always out of favor. Stocks are priced in the short term by investors’ perceptions and the emotions of fear and greed. It is when these perceptions are wrong that stocks can become undervalued or overvalued. The "value investor" will attempt to take advantage of these gaps or differences between a company's market value and its estimated intrinsic value. It all seems so simple; should one worry that all of the bargains will be snapped up by other value investors? Not according to Warren Buffett who stated in December 1985, "I have seen no trend toward value investing in the 35 years I've practiced it. There seems to be some perverse human characteristic that likes to make easy things difficult."

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In the investment world, one should always expect the unexpected. Just as everyone had capitulated and thrown in the towel, value was back. For the second quarter of 1999, value outperformed growth by a wide margin. The S&P 500/Barra Value Index rose by 10.80% versus 3.83% for the S&P 500/Barra Growth Index. In addition, small and mid-cap stocks outperformed their larger counterparts as can be seen in the chart below.

Second Quarter 1999 Returns

Index	2nd Qtr 1999	Yr Ended 6/30/99
DJIA	12.5%	24.7%
S&P 500	7.0%	22.8%
S&P Mid Cap	14.1%	17.2%
Value Line	13.8%	-2.3%
Russell 2000	15.1%	0.1%

We expect the trend of value outperforming growth to continue over the near term for several important reasons. 1) The Fed's (Federal Reserve Board) unwillingness to tighten credit aggressively should lead to continued strong economic growth, which has historically been bullish for performance for value styles of investing. 2) Despite the shift from growth to value over the past quarter, there is still a wide gap in valuations. At quarter end, the S&P 500 Index (largely a large-cap growth index due to index weightings) was trading at approximately 26 times projected 2000 earnings, while the median stock in the Value Line Index currently trades at approximately 18 times projected 2000 earnings. 3) Most growth stocks are valued using dividend discount models, which by theory would project a lower fair value in times of rising interest rates. 4) According to the Frank Russell Company, the second quarter was the first quarter in the last six quarters that value outperformed growth which would indicate that the shift to value has not yet been exploited by the masses. After experiencing redemptions for most of the year, value funds drew in a net of approximately $470 million in May, reversing an outflow of $4.8 billion in April. Growth funds on the other hand attracted $11.5 billion and $5.99 billion in April and May respectively.

FED Rate Hike

As expected, the Federal Reserve Board moved on June 30th to raise the target rate on Federal Funds to 5.0%. This represents the first such increase in two years. While an increase in interest rates is usually not received well by the financial markets, it was greeted with "exuberance" this time. In the context of the FED's comments, the Federal Open Market Committee announced that with the increase they were returning to a neutral bias, from one towards tightening. Confusing the issue even more was that the release occurred on the last day of the quarter with a little under two hours left before mutual fund books closed out their second quarter. What resulted was a huge spike up in stocks and bonds at quarter end as "window dressing" kicked in big time. Apparently, most mutual fund managers did not want to show any "cash assets" at quarter end.

It should be noted that a neutral bias does not preclude a monetary policy change by the Federal Reserve. It is really too early to believe that the Fed will be on hold until August. Before the next Federal Open Market Committee meeting there will be one more Labor Department report, two CPI reports and two retail sales reports. The Fed will also have a reasonable read on the second quarter GDP. Going forward, we will closely monitor economic releases in an attempt to determine whether the Federal Reserve will have to implement a tighter stance. From a fixed income perspective, we believe our short duration portfolios are structured so that we could ride through a couple of more tightenings without considerable damage.

As we stated earlier, we believe that in light of the Asian recovery and strong domestic economy, value strategies will outperform over the coming months. Earnings comparisons for many of the cyclical companies should be relatively easy for the next few quarters while many of the stable, consumer companies continue to run into earnings disappointments (i.e. Pfizer, Coca-Cola, Gillette). We will be alert to take advantage of opportunities to increase exposure in such areas if they become attractively valued. We will continue to place client assets where we find value, keeping our research effort consistent with the concept to always invest with a margin of safety. We believe that we have entered a period where investors will be required to think, rather than follow the masses. Lost opportunities will not change one's economic status, however, a permanent loss of capital might. We truly believe the Internet will change the way every company does business in the next century. What is unclear is who will be the ultimate winners and losers. The low barriers to entry will constantly drive down prices and profits preventing many from becoming sufficiently profitable to warrant investment, especially at the current lofty levels. It wasn't too long ago that the PC industry was expected to be dominated by Apple, Atari, Commodore and Tandy. As it turned out, only a couple are still around and none are dominant PC manufacturers. A similar scenario is likely to play out in the Internet sector over the next decade or two. Below are two companies that we believe are attractive and the rationale behind each:

<u>Media General Cl A (MEG/A) ASE $52.0625 (07/07/99)</u>

Media General is a diversified communications/media company located primarily in the Southeastern United States. The company has interests in newspapers, broadcast television, recycled newsprint production and diversified information services. In April 1999, Media General announced that it had reached an agreement with Cox Communications to sell its cable television assets to Cox for $1.4 billion. When the deal closes, MEG/A will essentially be a debt free company with approximately $100 million in cash. Media stocks are typically valued on an Enterprise value/EBITDA basis and using 2000 pro-forma estimates (assumes the closing of the cable transaction) the stock is currently trading at an Enterprise Value/EBITDA multiple of 5.5 times versus the average for the newspaper group of close to 10 times. On an earnings basis, the stock is trading at less than 17x the 2000 estimate of $3.17 per share, a large discount to the group and the S&P 500. While there has been some uncertainty as to whether the company will make dilutive acquisitions with the sale proceeds, we believe this stock is too cheap to pass up at current levels.

<u>Alaska Air Group Inc. (ALK) NYSE $43.125 (07/07/99)</u>

Alaska Air Group is the holding company for Alaska Airlines and Horizon Air Industries. Believe it or not, we have concluded that the airline industry will emerge as one of the winners from the Internet revolution. Through the Internet, travelers can book flights without the use of a travel agent; a transaction booked online costs the airline only about 25% of what one costs that is booked through the traditional travel agent. Alaska Air is a leader in e-ticketing and currently gets approximately 5%-8% of passenger revenue from online ticketing compared to 1-%-2% for most carriers. ALK believes that if it reaches its goal to book half its tickets online by 2003, savings on distribution costs could approach 50%. The airlines can also use the Internet to generate revenues through e-marketing programs and special fares. The use of this "auctioning" of seats could also have positive implications for the load factor (or the average percentage of seats filled on each flight). Wall Street doesn't seem to be excited as Alaska Air trades at only 8.3 times the earnings estimate of $5.14 for 2000. The stock has declined over 30% from its 52-week high and currently trades at only 1.5 times book value.

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