Jolley Asset Management
Investment Outlook

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"We have no idea how long the excesses will last, nor do we know what will change the attitudes of the government, lender and buyer that fuel them. But we know that the less prudence with which others conduct their affairs, the greater the prudence with which we should conduct our own affairs"

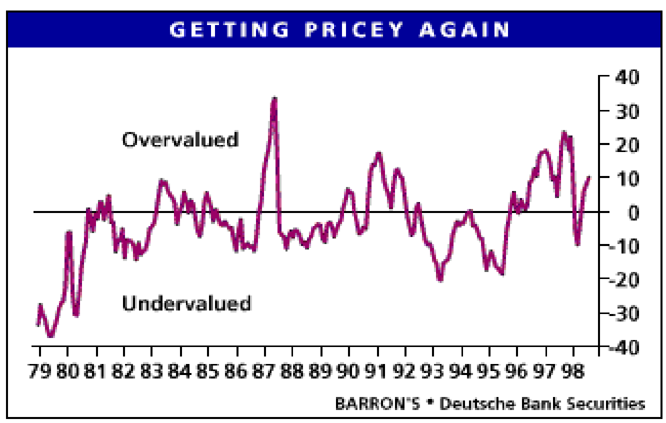
Warren Buffett--1989

In investing it is important to understand that prices are largely driven by investor psychology and the human emotions of fear and greed. As Mr. Buffett explains above, it is prudent to become more cautious in times of speculative excesses and more aggressive in times of fear. The investing public obviously doesn't subscribe to this theory; in fact, the explosion in the internet related stocks has become a craze reminding one of the "tulipmania" experienced in Holland in the period around 1635.

In Charles Mackay's book, *Extraordinary Popular Delusions and the Madness of Crowds*, Mackay wrote "At first, as in all the gambling mania, confidence was at its height and everybody gained. Many individuals grew suddenly rich…one after the other, they rushed to the tulip marts, like flies around a honey pot. Nobles, citizens, farmers, mechanics, seamen, …dabbled in tulips. People of all grades converted their property into cash, and invested it into flowers. Houses and lands were offered for sale at ruinously low prices, or assigned in payment of bargains made at the tulip-mart."

Needless to say, the tulip bulb frenzy did not have a pretty ending as prices ultimately plunged. The mania in internet stocks is similar to "tulipmania" as prices have risen far above their potential business enterprise value. America Online, which is the internet leader, has a market capitalization of approximately $71 billion versus revenues of $2.9 billion and a sporadic earnings history. The market cap of America Online exceeds that of PepsiCo, Gillette, or General Motors. Amazon.com, (the online bookseller) has a market cap of $18.6 billion, which is said to be larger than the entire domestic book industry's annual revenues. E-bay (an online auction site—where 10% of revenues come from Beanie Baby sales) has a market capitalization of $11 billion, while revenues only totaled $12.9 million in the third quarter. While difficult to predict when this frenzy will end, it is clearly not sustainable. Let me point out, that I embrace technological advances and change and use the internet in my business and personal life on a daily basis. As an investment theme, however, I cannot make rational sense of the current market valuations.

As we discussed in our "Investment Outlook" this fall, we felt that stock prices might bottom as mutual funds closed out their fiscal year end around October 31. While this prediction was pretty accurate, we are extremely surprised by the magnitude of the rise off of the bottom. The easings by the Federal Reserve board headed off a global crisis, but has potentially created the return of "irrational exuberance" in the equity markets. (Greenspan first mentioned "irrational exuberance in December 1996 with the Dow Jones Industrial Average at 6500.) As it turned out, for the year, stocks generated double digit returns for an unprecedented fourth



consecutive year. Once again stocks were led by the "nifty-fifty" and the top ten performers accounted for approximately

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42.5% of the entire S&P gain. As can be seen from the chart on page 1, the Federal Reserve Board's dividend discount model currently shows the market as being approximately 10% overvalued. While the model has been a good gauge of market direction, trouble usually arises when it reaches the 20% to 30% overvalued territory. In March 1998, the model showed the market as being 18% overvalued, however, stocks continued to move higher, until topping out in mid-July. The model is really quite simple, comparing the earnings yield (reciprocal of the P/E ratio) on the S&P 500 index (based on 1999 earnings estimates), to the risk free rate currently available in the form of ten year treasury bonds. The biggest problem in using the model, is having accurate earnings forecast for the coming year. I/B/E/S is currently projecting earnings growth of 17%; a number that we feel is too optimistic. Obviously if consensus earnings estimates are too high, the overvaluation as suggested by Greenspan's model would be considerably understated. As it stands the market is trading at approximately 27 times 1998 operating earnings and 23 times 1999 estimates. While the market is clearly expensive, we are using a "bottom-up" process to uncover values in many "out of favor" issues. While the "nifty-fifty" is way over-priced in our opinion, values can be found in the broader market as evidenced by the median P/E on the Value Line Index which is approximately 16x 1999 estimates.

Figure 1-Divergent Equity Returns for 1998!

Index	4^{th} Quarter	Yr. ended 12/31/98
Dow Jones Indus.	17.58%	18.17%
S&P 500	21.28%	28.58%
S&P Eq Wtd	15.40%	7.13%
S&P Mid Cap	28.17%	19.11%
Value Line *	14.07%	-3.79%
Russell 2000*	16.05%	-3.45%

**Does not include dividends*

As can be seen from table 1 above, there was a wide disparity in returns in 1998. This is quite evident when comparing the returns on the S&P 500 (market capitalization index) with the S&P 500 equal weighted index. The market capitalization index outperformed the equal weighted counterpart by some 21.4% for the year ended 12/31/98. "Bigger" has clearly been better over the last few years as investors have flocked to passive index strategies and many equity managers have developed "closet-indexing" strategies. The decision by most portfolio managers has become, not whether the stock price is attractive versus its inherent business enterprise value, but rather, what percent of the index it comprises and do we want to over-weight, market-weight, or under-weight the position. We believe that this strategy will ultimately fail, as the price one pays for an equity security will largely determine the return one receives from that particular investment. When constructing equity portfolios, we think it is essential to judge the merits of that security based on "absolute" valuation criteria, not just "relative" valuation criteria.

Other major events that investors will focus on in 1999 include the introduction of the EMU and the Euro and the Year 2000 issue.

Economic and Monetary Union (EMU) – On January 1, 1999 the "Euro" was born in an attempt to form a single European currency and market. A European Central Bank has been formed that will operate much like the Federal Reserve Board does in the US. This should result in more disciplined fiscal policies and potentially lower interest rates. By most accounts, the EMU should favorably impact Europe's economy and European stocks. It will also make it easier for a US corporation to do business in Europe as they will only have to focus on one currency. On the other hand, if the "Euro" becomes accepted as a "safe-haven" currency it could have negative implications for the US dollar and US bonds.

Year 2000 (Y2K)—Economist have been shying away from assessing how this well documented event will impact the global economy. Ed Yardeni, chief economist at Deutsche Bank Securities, has gone on record in stating that he "sees a 70% chance that the world will drift into a decline on par with the 1973-1974 recession". While it is impossible to predict the economic impact of the Year 2000, it is probably safe to assume that it will result in some slowdown on the global economy, and certainly add to the volatility in the global financial markets.

Summary--The year just ended could be summarized as "bull market", then "bear market", then "bull market" again; or more simply very volatile. We believe that this will continue into 1999. Equity return expectations are probably too high, although we believe it is still too early to call for an outright "bear market" phase. Inflation should remain under control, creating value in short to intermediate high quality bonds. We believe the Fed will now have to take a "wait and see" attitude, largely due to the strength in the equity markets. We believe a disciplined, value approach will serve our clients well over the coming year. *Frank G. Jolley, CFA*