Jolley Asset Management
Investment Outlook

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"First, while it sounds like a tale from Lewis Carroll, the best investment strategy for 1999 has been to invest in companies that lose money. No kidding." L. Keith Mullins, Salomon Smith Barney

This past year will certainly go down as one of the strangest in Wall Street history. It was a tale of two economies and two stock markets, both sending out wildly different messages. The technology sector and NASDAQ (largely technology) were in what appears to be a speculative mania, while the rest of the market (the old economy) was essentially in a bear market. The "new-economy" is being driven by technology and the Internet-economic model has clearly captivated investors. The price/earnings ratio is out, the IPO (initial public offering) is in and the most important market news isn't being made on the floors of the New York Stock Exchange. As Prudential's Ralph Acampora stated, "Everyone is buying concepts and not earnings. NASDAQ's got wings. It's the sizzle, and who cares about the steak." The speculative mania has been further fueled by the media hype, with CNBC commentators serving as "cheerleaders" and "pom-pom girls" on the sidelines.

Perhaps the media infatuation with the internet climaxed on December 27, 1999, when *"Time Magazine"* named Jeff Bezos, the CEO of Amazon, as its Person of the Year. I must admit that I enjoy shopping at Amazon; and when they offered a $10 coupon with every $25 purchase, I just couldn't refuse. Selling below cost is not my idea of an attractive business model; however, Wall Street seems impressed by their ability to gain customers at a rapid clip. The competitive nature of the internet, in which rival e-tailers are just a mouse click away include a great deal of business risk. Never mind the fact that the market capitalization of Amazon is approximately $27 billion, which already surpasses that of J. C. Penney, Sears, Toys R Us and TJX combined. In addition, Amazon is expected to lose over $300 million in 1999 versus combined estimated profits (Value Line) of $2.8 billion for Penney, Sears, Toys R Us, and TJX. It should also be pointed out that the old-line retailers are also developing an internet presence to defend and grow their existing franchises. Warren Buffett was recently quoted in Fortune Magazine, "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all the durability of that advantage."

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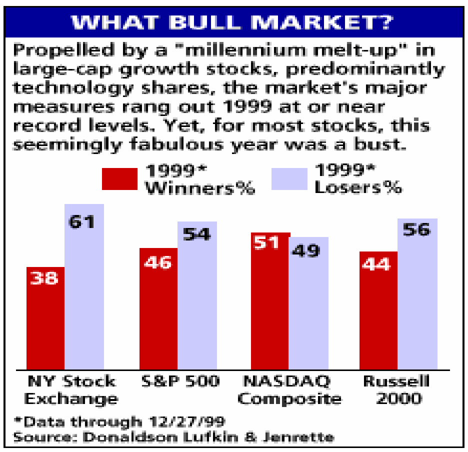
The United States has been and will continue to be on the threshold of a technological revolution. We have no problem with technology or its growth prospects for that matter. We believe the problem lies in the valuation. According to Dr. Edward Yardeni of Deutsche Banc, the technology sector trades (as of 11/22/99) at 52.7 times trailing earnings and the communication sector at 48.3 times trailing earnings. In the chart below, the tech laden NASDAQ shows a trailing price/earnings of a staggering 170x, and this did not include December 1999, when it was estimated by George Gilman to have risen by another 30 multiple points to 200 times. As L. Keith Mullins put it in a November 19, Emerging Growth stock report, "First, while it sounds like a tale from Lewis Carroll, the best investment strategy for 1999 has been to invest in companies that lose money". The report pointed out that in the Russell 2000, 15% of the companies in the index are losing money but their stock prices have advanced approximately 50%. The same held true for their mid (Russell Mid-Cap) and large-cap (Russell 1000) counterparts; the companies losing money in those indexes advanced 107% and 97% respectively.

Source: Barron's Magazine

Red Hat, Inc., the Linux software company based in the Research Triangle, is the perfect example. Its stock has skyrocketed after a recent IPO to a market cap of just under $17 billion even though the company lost $3.6 million dollars on sales of $5.4 million in its most recent quarter. In contrast, Wachovia Corporation, a premier regional bank holding company, has a market capitalization of less than $14 billion and is expected to earn over $1 billion in 1999. By the way Wachovia shares declined 22.2% in 1999.

The strength in the technology sector has resulted in its weighting in the S&P 500 increasing to over 25% versus 11% in 1995. Technology and communication companies now represent over 33% of the S&P 500, up from 22% just two years ago. In our opinion, the S&P 500 Index has lost its effectiveness as a proxy for the overall market due to the fact that it is now totally dominated by just a few stocks. At year end, 32 stocks (dominated by technology) made up 50% of the S&P 500 index. The chart below gives a truer picture of what transpired in the broad domestic equity markets in 1999.



The table below also shows the divergent market trends that existed in the past year. As the chart points out, the market capitalization weighted indexes experienced strong performance, while the equal-weighted indexes (Value Line Index and S&P 500 equal-weighted) lagged dramatically.

Index	4th Quarter 1999	Yr. Ending 12/31/99
DJIA	11.6%	27.2%
S&P 500	14.9%	21.0%
S&P 500(Eq Wt/Geometric)	4.1%	3.1%
S&P Mid Cap	17.2%	14.7%
Russell 2000	18.1%	19.6%
Value Line	3.2%	-1.4%

What differentiates a disciplined value manager such as Jolley Asset Management from others really relates to how one looks at risk. Modern Portfolio Theory (MPT) believes that equity investors face two major risks: "specific company risk" and "market risk or systematic risk". Specific company risk deals with the business risk of the enterprise (i.e.; its ability to continue as a going concern, due to the economy, competitive forces, etc.) The theory goes on to point out that with proper diversification, one can essentially eliminate "specific company risk". "Market risk," on the other hand, is not related to the specific companies, but rather to the riskiness and volatility of the overall market. Today's portfolio managers are largely not concerned with individual security selection or overall market risk. All they are trying to do is outperform some pre-determined benchmark index or "bogey". They take the approach that if Lucent drops by 25% in one day, who cares, all of my competitors own it as well and we lose no ground relative to the benchmark or the competition. Today's portfolio manager also is largely not worried about diversification either. The S&P 500 index is heavily concentrated in a few large-cap names (largely technology) so the manager's approach is that we have to own them even if it means that we are really running a concentrated portfolio, with the concentration being in the most over-priced issues. What today's portfolio manager is most interested in is benchmark risk, the risk associated with under-performing a specific benchmark and losing his or her job or bonus. In essence today's portfolio manager is focusing on risk relative to a benchmark, not absolute risk at the company or portfolio level. This focus also explains the move to "closet-indexing", where portfolio managers essentially mimic a benchmark index. Over the last few years more and more portfolios are aligning themselves to look more like their benchmark. Morningstar found that in the three years ended August 1999, the "R-Squared" which gauges the correlation between a fund and whatever index; usually the S&P 500, had risen to 74 from 58 three years earlier. In large-cap funds the correlation has risen from 71 to 86 over the past three years. In simple terms, it is evident that increasingly, everyone is buying the same stocks.

Jolley Asset Management is a disciplined value investor. We believe that in the long term stock prices are ultimately driven by the earnings and cash flow of a business, and the risk in that enterprise is largely related to the sustainability of those cash flows. The company's competitive position is extremely important and we prefer to buy companies where we believe the business franchise offers us a "margin of safety". While we pay attention to relative risk, we are more concerned with absolute risk when we purchase a security. We are just as focused on the balance sheet and downside as we are the potential for capital gains. We also believe that dividends are an important component of total returns. Last year only one of the top fifteen performers in the S&P 500 even paid a dividend.

The bifurcation of today's markets creates wonderful buying opportunities to the contrarian value manager, such as Jolley Asset Management. We believe we are at a critical inflection point, where an investor must be willing to swim against the tide, even if it means foregoing short-term performance. It is our belief that great long term investment records are made by making tough decisions, which many times may mean going against the herd mentality. Buying what is popular has never worked on Wall Street. That is precisely why Jolley Asset Management was formed, to provide a vehicle whereby our focus and discipline could be preserved. We firmly believe our clients will be rewarded handsomely.

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