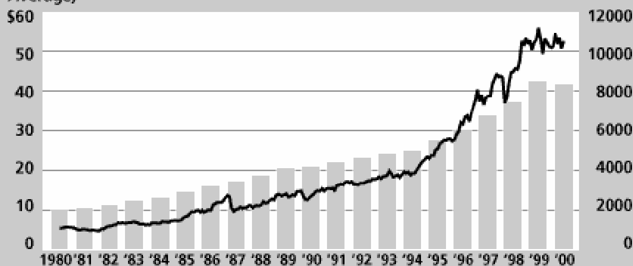
JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 12 • Spring 2001**

"Bubbles have always given back everything. There have been no exceptions-None." -Jeremy Grantham

Over the past couple of years we have warned on numerous occasions that the Nasdaq and technology sector had entered into what we considered to be a "speculative bubble". As we quoted Microsoft President, Steve Ballmer in our "*Fall1999-Investment Outlook",* "There's such an overvaluation of tech stocks it's absurd, and I'd put our company's stock in that category." We later highlighted Warren Buffett's quote from last years Berkshire Hathway annual meeting (4/29/00), "In time people will see this era as one of enormous wealth transfer, but the only wealth actually created is by the businesses. Investors as a whole may feel richer, but they're not. It's like a chain letter. The early participants can make a lot of money, but no wealth is created. In fact, due to frictional costs, wealth is destroyed." Once again Mr. Buffett was dead on, and in fact few would now argue that wealth has been destroyed over these last couple of years. A recent report from the Federal Reserve Board showed that household net worth declined by more than 2% last year, its first such decline in at least fifty-five years.



The talking heads at CNBC and financial journalists are busy debating whether we have officially entered a bear market; with comments such as "The Dow Jones Industrial Average entered bear market territory but rebounded to close in a corrective phase." Let us be perfectly clear in stating that the domestic equity market is clearly in a "bear market". A bear market starts the moment the bull market ends. The irony is that it is often not identifiable until after the fact and in hindsight. Bull markets typically end when the news is wonderful and the best has been discounted into equity prices. Bear market bottoms typically occur when the economy is in recession (also not often identifiable until after the fact in hindsight) and the news is at its worst. Trust me on this , watching CNBC and reading the financial press has been will continue to be hazardous to your financial health. Also trust me when I tell you that CNBC will not help an investor call the market bottom or make a rational investment decision. After all, wasn't it CNBC who talked about all tech all the time? CNBC, in my personal opinion played a huge role in the "speculative bubble" and will pay the price as viewers leave them in droves over the coming months. The chart below shows just how much damage has been done to the domestic equity markets over the past quarter and year.

Index	1st Qtr 2000	% Decline from High*
DJIA	-8.0%	-15.7%
S&P 500	-11.9%	-24.0%
S&P Mid Cap	-10.8%	-16.2%
S&P Barra/Growth	-17.4%	-40.6%
S&P Barra/Value	-6.5%	-11.0%
Value Line	-6.2%	-27.4%
NASDAQ Comp.	-25.5%	-63.5%

Source:IDC **from all time high*

Our greatest fear has been that when the "bubble" in the tech sector was pricked, it would eventually pull the domestic economy and equity markets down with it. While the "old economy" tried valiantly to keep moving ahead over the past year, it appears that now the downside momentum in the technology sector has essentially spilled over into the rest of the economy. The net result appears to be an economic recession and bear market to go with it. So we think now might be a good time to discuss some of our observations about the current environment and discuss how Jolley Asset Management, LLC will proceed over the coming months.

Bear Markets

First of all, as we discussed above, we typically don't know when we are entering a recession or bear market until after the fact. This is important, because many times a significant part of the damage is already done and in reality it may be too late to sell. Morgan Stanley strategist, Barton Biggs recently stated, "My guess is that the bear market is 75-80% over in terms of price but maybe only half over in terms of time. But we are getting there, and we must remember to become more bullish, not more bearish, as prices decline. Momentum is inversely correlated with value." According to the Leuthold Group, there have been ten bear markets since World War II, with the average bear market decline measuring 29% in terms of decline and 15 months in terms of duration. So, if history is any guide, it would be safe to assume that much of the pain is behind us. As the chart above displays, most of the major indexes have

already declined precipitously from their all time highs and are rapidly approaching the average bear market decline (the NASDAQ and S&P Barra/Growth index have actually plummeted 63.5% and 40.6% respectively.) So, if history is any guide it would be safe to assume that much of the pain is already behind us. Furthermore, Jolley Asset Management has always believed that market timing is a futile exercise, especially for the individual investor, when tax ramifications are taken into consideration. With those factors in mind, we are intent to remain committed to what we believe to be high quality, undervalued equity securities for the long term.

Valuations

While it may seem contradictary to the preceding paragraph, we believe it is naïve to believe a stock or market is cheap, just because it is down a lot. As we have discussed for two years now, we have experienced one of the most speculative bubbles in the history of financial markets and quite frankly, we do not know what the ramifications will be with regards to capital spending or consumer spending for that matter. Furthermore, many stocks are simply not bargains even at these lower prices. Currently the S&P 500 trades at approximately 22.8 times trailing earnings, but this number is skewed upward by the fact that the S&P 500 is market capitalization weighted. As we have discussed for a few years now, the largest capitalization stocks ("Nifty-Fifty") in the S&P 500 have traded at valuation levels that we believed were excessive. While the multiple for the top 50 names has contracted dramatically over the past year (the forward multiple has declined from a multiple of 42.1x to 28.1x), this is still expensive in relation to prior periods. At the end of 1996 the S&P 500 traded at just over 16 times earnings. In our search for value, we are many times focusing on the bottom 450 names in the S&P 500, which trade at much more reasonable valuation levels. As the chart above shows, the median stock in the bottom 450 of the S&P trade at 16.7 times forward earnings. This is precisely why we believe our "multi-cap" value approach makes sense, it gives us the flexibility to gravitate to the areas of the market that are most undervalued at any point in time.

Index	Mean P/E 2001 Estimates	Median P/E 2001 Estimates
Top 50 Companies. In S&P 500	28.1x	25.9x
Bottom 450 Companies in S&P 500	22.5x	16.7x

Benchmarks

Over the past couple of years, we have spent a lot of time discussing the various benchmarks that investors use to judge mutual funds and money managers against. "Has the manager beat the S&P 500? If not, why shouldn't I replace them?" I believe that this is where many investors got in trouble over these last couple of years, by focusing on returns relative to an index, rather than the focusing on the amount of risk inherent in the underlying strategy (or index for that matter). In bull markets, investors focus on relative returns (greed), in bear markets they tend to focus on absolute returns (fear). Over these last few years, we have intentionally tried to ignore the popular benchmarks, such as the S&P 500 and focused on stocks of companies that we felt were attractive from a risk/reward profile. After all, Standard & Poors and Dow Jones jumped onto the "new economy" bandwagon with numerous index changes over the past year. We find it ironic that when Standard & Poor's decided to include Yahoo! in the S&P 500 Index last year, it was essentially a small company (approx. $1 billion in revenues) with an enormous market capitalization (approx.) $100 billion at its peak). Thank you Standard & Poors! Today, Yahoo! Carries a much more reasonable market cap of approximately $9 billion but still not cheap when compared to revenues of approximately $1 billion. Equally disturbing is the fact that many portfolio managers feel that the inclusion of a specific stock in an index serves to validate the decision to buy the issue without regard for valuation or further due dilligence. It is our belief that investors should primarily focus on performance from the perspective of whether the portfolio has grown over time and if the returns reasonable in light of the client investment objectives and risk profile. After all, the reason we invest is to enable us to reach longer term financial goals such as retirement or education funding.

The Federal Reserve Board (FED)

Over the years, it has paid investors to focus on the Fed, but it seems that today that focus has been replaced with criticism of the Fed and the fact that many believe they are not moving to lower rates fast enough. I guess if I was running a $20 billion dollar mutual fund that was down 60% or so, I would try to find a scapegoat also! While we believe the Fed has made some mistakes, specifically the massive easing in 1998 due to the potential collapse of LTCM (which helped fuel the NASDAQ bubble); it is our opinion that history will repeat itself again and that the Fed easings will eventually turn the economy and markets around. There have been three consecutive rate cuts only eleven times in history. In ten of these instances the Dow Jones Industrial (DJIA) and S&P 500 have increased over the following twelve months by an average of 18.3% and 17% respectively (even when factoring in significant losses in 1930). Excluding 1930, the gains for the DJIA and S&P 500 were 23.7% and 21.5% respectively. While the equity markets have failed to cooperate so far, we believe that with a little patience we will see a recovery take hold.

111 Candlewood Road, Suite B
P.O. Box 7967
Rocky Mount, NC 27804
(252) 451-1450 Toll Free (877) 4-JOLLEY
Web Site: www.jolleyasset.com
E-Mail: fjolley@jolleyasset.com