JOLLEY ASSET MANAGEMENT, LLC

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"What you've recently seen (stock market) is just a tea party. If you like me lived through 1973-74 or even the early 1990's…there was a waiting list to get out of the country club--that's when you know things are tough. "

Charles Munger--May 2001

The quarter ended June 30, 2001, saw the S&P 500 index and the NASDAQ Composite index put in their first quarterly gains in more than a year (the Dow Jones Industrial Average managed gains in the second and third quarters of last year).

Index	2nd Qtr 2001	YTD 2001
DJIA	6.7%	-1.9%
S&P 500	5.9%	-6.7%
S&P Mid Cap	13.2%	1.0%
S&P Barra/Growth	7.6%	-11.1%
S&P Barra/Value	4.4%	-2.4%
Value Line	8.3%	1.6%
NASDAQ Comp.	17.9%	-12.2%

The rally in equities came in spite of the fact that corporate earnings continue to erode at a rapid clip. In fact, earnings for companies in the S&P 500 are forecast to decline by over 17% in the second quarter from a year earlier, the worst year-over-year drop since the the third quarter of 1991. As you might expect, most earnings declines of this magnitude have typically occurred around recessionary nadirs. While government statistics showed that the first quarter GDP grew by 1.2%, for all practical purposes the domestic economy is in recession. The optimisim towards equities is primarily a function of the six Federal Reserve rate cuts, which Greenspan began back on January 3rd, bringing the federal funds rate down to 3.75% from 6.5%.

It is not unusual to see stocks begin to rise during periods of weak corporate earnings. Remember, most stocks peaked about a year ago, when earnings reports were at record levels, Now that many stock prices have declined precipitously, investors are beginning to look over the trough for an economic recovery and stronger profits six to twelve months out. In addition, it should be pointed out that monetary policy typically takes at least two or more quarters before it is able to work its way through the economy, implying that the Fed cuts should begin to stimulate the economy in the second half of 2001. Furthermore, the Federal Reserve has made it clear that they stand ready to move again, perhaps as early as the next policy meeting scheduled for August 21st.

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Last spring I attended my first Berkshire Hathaway, Inc. annual meeting in Omaha, Nebraska. My mind was cluttered by investors (or should I say market participants) infatuation with technology stocks, the new economy, and the internet. My thinking was, what better way to clear the mind than to get six hours with the greatest investor of our lifetimes. After all, if an investor had put $10,000 in the original Buffett Partnership in 1956 and reinvested in the common stock of Berkshire Hathaway at the partnerships termination in 1969, they would be worth today more than $270 million--after all taxes, fees, and expenses. Yet, in recent years, people have paid millions of dollars for get rich quick books, day-trading seminars, in home quote systems, etc. Think about this for a minute, people will pay thousands and thousands of dollars trying to find the road to riches, when the world's greatest investor will take six hours of a spring day to explain his investment philosophy for free. The only requirement is that one owns shares in Berkshire Hathaway Class A or B shares. Following last year's meeting , I made a commitment to attend the Berkshire meetings as long as Warren Buffett and Charlie Munger are around. After all, I owe it to my clients to do all I can to stay on top of the investment landscape and what better way to do it than to meet with the world's greatest investor for an annual update. So as we did in the *Investment Outlook* last year at this time, I thought now might be appropriate time to summarize some of the topics discussed at the Berkshire Hathaway annual meeting which was held in Omaha on April 28, 2001.

Thoughts from the Berkshire Hathaway Meeting

On Corporate Earnings and Expected Returns

Buffett: The probability of us achieving 15% growth in earnings over an extended period of years is so close to zero it's not worth calculating…it just can't happen over time. We will have years when we do it but it won't happen regularly. Nor do we think any large company can do it over a long period of time. There may be a couple that do, but predicting which ones is almost impossible. Fifteen percent is a dream world."

Munger: "It's simply crazy to have such very high expectations. Years ago 15% return was regarded as impossible, now they say so what." He went on to add, "I see more predictions of future earnings growth at a higher rate, not less. It's what the analysts want to hear." "Moderate expectations will serve us just fine."

Buffett: "Stocks are a perfectly decent way to make 6% to 7% returns over the next fifteen or so years, but anyone who expects to make 15% from the market or by having a broker pick stocks is living in a dream world."

On Corporate America's Exposure to Pension Fund Risk

Buffett: "Pension funds are projecting 9% annual returns. There is no way they will achieve this. It'll be interesting to see how quickly assumptions change."

Munger: "Pension fund accounting is drifting into scandal by using unrealistic assumptions. It's human nature to extrapolate the recent past into the future, but it's terrible that managements go along with this."

Buffett: "I don't know of any case in which corporations are reducing their investment return assumptions. Earnings would go down if assumptions were revised downward. If you try to talk to management, you get nowhere."

Munger: "The current practice is a dumb and improper way to handle it . If you talk to management, their eyes glaze over even before hostiliity comes."

On Assessing Risk

Buffett: "We regard using volatility as a measure of risk is nuts. Risk to us is 1) the risk of permanent loss of capital, or 2) the risk of inadequate return. Some great businesses have very volatile returns--for example See's (referring to See's Candies--a Berkshire Hathaway subsidiary) usually loses money in two quarters of each year--and some terrible businesses can have steady results."

Munger: "How can professors spread this? I've been waiting for this craziness to end for decades. It's been dented, but it's still there."

Buffett: "If someone starts talking to you about beta, zip up your pocketbook."

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On The Internet Threat

Buffett: "We view the Internet as less of a threat to retailers than a year ago. Opportunities are available for certain of our businesses, such as GEICO and See's Candies. Very few turned wealthy from the Internet from cash results but rather from public investment."

Munger: "Grocery delivery is an example. Cost of delivery are still there whether you do it with the Internet of with a pad or pencil."

Buffett: "The Internet captured the greed and dreams of people that were gullible to the promoters. This was a huge money trap for the public."

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Summary

A survey reported in the Wall Street Journal at the end of the first quarter of 2001, showed that 41% of investors expect their stocks to return 10% to 20% annually over the next 10 years. Fully 20% of investors expect returns in excess of 20% annually. While the decline in the stock market over the past year may have been painful, it has really done very little to dampen investors enthusiasm with regards to the long term expected returns.

Essentially, there are three basic components to equity returns: 1)Earnings Growth 2, Dividends and 3)Price/Earnings multiple expansion (contraction). Corporate earnings growth of 6% coupled with the 1.2% yield (S&P 500), could result in long term equity returns of approximately 7.2%, assuming all other things being equal. However, all other things are really not ever equal, and this is what makes us most uncomfortable with regards to the current market environment. According to Kent Engelke of Anderson & Strudwick, during the last recession the S&P 500 bottomed at 12.5 times earnings in the fourth quarter of 1990. As of June 30, 2001 the S&P 500 Index was trading at almost 27 times trailing earnings. At this juncture, our two biggest areas of concern are how quickly earnings will rebound and the potential for price/earnings multiple contraction (valuation) over the coming years. Our equity strategy will continue to search for value in the equity market regardless of market capitalization.