Jolley Asset Management
Investment Outlook

Volume 1, Issue 11 **Winter 2001**

As we stated one year ago:

"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."

Excerpt from Investment Outlook
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Winter 2000/(1/15/00)

Back in 1996, I was lucky enough to attend a conference, where John Neff, the legendary portfolio manager of the Vanguard Windsor fund, spoke at a dinner meeting. (The Windsor fund beat the market by an average of over 3.15% per year for over thirty years). Mr. Neff"s topic of discussion was "coping with difficult markets", and he talked in detail about each time the Windsor Fund had lagged the market by a substantial margin and how he dealt with each situation. The most significant part of the discussion was that in each case, Mr. Neff never really changed what he had been doing all along, what changed was the markets eventual realization of value. Where Mr. Neff was different was that he had the discipline and the uncanny ability to go against the tides of conventional market opinion. When Neff was questioned about what was the most difficult market environment he ever encountered, he answered it was not the recessionary bear-market years, but the "nifty-fifty" market of the early 70's, a period not unlike the recent "bubble" in the NASDAQ. What made the NASDAQ "bubble" similar to the "nifty fifty" was largely a general perception that if one buys good companies, price doesn't matter. I would expect, that at least for the time being, this past year reminded everyone that the price one pays does matter. As Benjamin Graham stated in the 1934 edition of *Security Analysis,* "An issue is attractive only if the indicated value amply justifies the price paid; hence the price is an integral part of any investment decision."

We missed out on much of the "tech party" in 1999 and I must admit, from my perspective, it was the most challenging market environment that I have ever encountered (and that includes the 1987 crash). We had warned for some time that the valuations in the technology sector were not sustainable and that while having growth attributes (tech) was still a cyclical industry. While confident the "bubble" would eventually burst, we had no idea how long the process would actually take. As a *Wall Street Journal* article pointed out, it was "All tech, all the time. Playing momentum pays. Buy on the dips. Valuation is for wimps." Wimps or not, we felt vindicated to have missed the peak to trough plunge of 54% in the NASDAQ Composite Index, bringing the full year decline to 39.3%, the worst year since it was created in 1971. The decline in the technology sector was largely

Index	4TH Qtr.	2000
DJIA	1.73%	-4.67%
S&P 500	-7.82%	-9.10%
S&P Mid Cap	-3.85%	17.49%
S&P/Barra Growth	-16.72%	-22.08%
S&P/Barra Value	1.63%	6.08%
Value Line	-6.28%	-8.71%
NASDAQ Comp.	-32.74%	-39.29%

JOLLEY ASSET MANAGEMENT LLC

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

responsible for the 9.1% decline in the S&P 500, its worst year since 1977. The bright spot was that excluding technology, the S&P 500 declined only 4%, and most value and mid-cap indexes actually fared quite well.

This past year probably has convinced a number of market participants that the investing game is not quite as simple as some had come to believe. While we expect some recovery in the stock market averages this year, we remain convinced that the years of 25% returns are probably not in the cards. Probably the biggest problem facing the equity markets today is the weakening economy and the impact on corporate earnings. While it is still too early to tell, the U.S. economy may be entering in or already be in a recession. The tricky thing about economics and statistics is that by the time the government statistics officially confirm a recession, it is usually about over. Remember a recession is when we experience two consecutive quarters of negative GDP growth. Recession or not, corporate earnings have already started to show signs of deterioration. According to First Call/Thomson Financial, approximately 52% of the companies that had provided previews of their upcoming quarterly earnings warned that they will miss analysts expectations. Despite the dramatic economic slowdown, many on Wall Street are expecting earnings on the S&P 500 to rise 7-10%. Capital spending has increased at approximately 26% per year since 1996 (and from 9% of GDP in 1992 to 16% now), fueling much of the growth in the domestic economy. However, technology spending has recently slowed dramatically, and if recent trends continue, we could actually see a decline in technology spending in 2001. Couple that with a tapped out consumer (remember our previous discussions about the "wealth effect" and the impact that rising or declining stock prices have on consumer spending patterns) and the profit picture begins to look questionable at best.

Apparently, Federal Reserve Chairman Alan Greenspan has become alarmed as well, and on January 3, 2001, the FED moved to cut interest rates by 50 basis points, before the regularly scheduled Federal Reserve meeting on January 31st . "This says to me that Alan Greenspan is considerably--not just a little, but considerably--more worried about the health of the economy than the consensus forecasts," said Princeton University economist Alan Blinder. Mr. Blinder who previously served as Greenspan's vice-chairman added, "…and if things are deteriorating as rapidly as Greenspan must think, this will not be enough to stop the deterioration." We concur and would not be at all surprised to see the Federal Reserve follow up with another rate cut at the January 31st Federal Open Market Committee meeting.

jumped 20% on average in the twelve months following a rate cut. From a purely historical sense the numbers clearly favor a "Don't fight the Fed" mentality. However, we would caution that the economy typically responds to the rate action with a lag of six to twelve months. For this reason, one should expect the economic and earnings deceleration to continue for at least a few quarters.

It is also important that we pay attention to current valuation levels in the domestic equity market. Now that the NASDAQ bubble has burst, everyone seems to agree that valuations do matter. In other words, how is a particular company or index valued versus its intrinsic value or worth. One important valuation parameter that merits important consideration is the price/earnings ratio. While many stocks and indexes have declined precipitously, we should not assume that the underlying stock (or index) is cheap without further analysis. Even now, many stocks remain overpriced (in our opinion) in comparison with their historical price/earnings ratios (see chart below). As of 12/31/00 the trailing price/earnings ratio of the S&P 500 stood at 24.6 times, which is significantly above the average multiple for comparable periods shown below (inflation rate now approx. 3.4%).

Inflation Rate (%) 1955-1994	Number Of Months	Average S&P 500 P/E
Less than 3.0%	175	17.5
3.0%-4.0%	***87***	***16.1***
4.0%-5.0%	62	14.9
5.0%-6.0%	43	14.5
6.0%-7.0%	33	10.9
Greater than 7%	76	9.0

Source: Nomura Securities/Financial Analysts Journal

In summary, while Federal Reserve easings typically signal better times ahead for the equity markets, we remain somewhat cautious with regards to the intermediate outlook. The economy is deteriorating rapidly which will continue to create short-term problems for corporate earnings. In addition, while many stocks have corrected considerably from their highs, many remain in our opinion to be somewhat over-valued from a historical perspective. As always, we will be looking to add quality common stocks as they become attractively priced versus our estimate of intrinsic value. We would anticipate the portfolio moving towards more economically sensitive names as we expect the Federal Reserve actions to result in a stronger economy one year out. Our value discipline has served us well through a difficult market this past year, and we believe it will prove its worth once again in this challenging environment. We remain committed to owning what we believe to be high quality, undervalued equities for the long term.

Frank G. Jolley, CFA