JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 18 • Fall 2002**

"A correction is when the other fellow's stocks go down; a bear market is when your stocks go down too."
James Gipson
Pacific Financial Research

An ugly September closed out the worst quarter since the stock market crash in the fourth quarter of 1987. The damage was widespread, with growth, value, large-cap, small-cap and foreign stocks all experiencing double-digit declines (see chart below). The only winner on the quarter was investment-grade bonds, as interest rates plunged in the face of a stalling economy and war fears. The ten-year Treasury bond returned over 11% on the quarter.

Index	3rd Qtr 2002	YTD 2002
DJIA	-17.4%	-23.2%
S&P 500	-17.3%	-28.2%
S&P Mid Cap	-16.5%	-19.2%
S&P Barra/Growth	-14.1%	-28.6%
S&P Barra/Value	-20.5%	-28.0%
Value Line	-24.6%	-33.8%
NASDAQ Comp.	-20.0%	-39.9%

As of October 9, 2002, the S&P 500 index has declined by more than 49% from its highs of 2000. This makes it the worst bear market since the 1930's. As this torturous environment hits the 2½ year mark, we know it's trying the patience of most investors. We empathize because our patience is also wearing thin. But at times like this we take great comfort in our investment discipline and value orientation. As you know it was only a little over two years ago when all the experts and media were urging everyone to buy the internet and technology stocks and had price targets on the Dow Jones Industrial Average of 14,000 to 15,000. Today many of those same experts have done an about face, calling the market overpriced and predicting lower prices ahead. As our clients know, we disagreed with the experts thirty months ago and we disagree with the extreme negative thinking of today. We believe an investor should take a more constructive view of the markets in light of the significant decline. Our thoughts are summarized in the following Q & A.

Why does the market continue to drop?

1) **Economics and Profits**: The economic recovery is faltering and forward looking economic measures are deteriorating. The weakness is most apparent in the manufacturing sector. Consumer spending has been a bright spot, but has recently begun to show signs of weakness as well. Although corporate profits have recovered somewhat, the rebound has been tepid. In addition, earnings estimates were too optimistic and have been coming down throughout the year.
2) **War:** The economic relevance of war is primarily the risk that oil exports out of the region are disrupted. Though this seems to be a low probability, anything that destabilizes the Middle East tends to worry investors. A secondary concern is the possibility that a war with Iraq could have ripple effects in a very unstable region that might fan terrorist flames.
3) **Bubble Aftermath:** In the early days of 2000, many investors were unconcerned about valuations, fundamentals or any sort of rational analysis of the risk. The last few years have served as a true reality check. Investors are now much more cognizant of risk, so much that their angst may be causing many to shift to a much more defensive posture. There is great concern about the economy and Iraq, but it doesn't end there. There is also great confusion about current valuations (see next question below). It is not unusual after bubbles for the investor sentiment pendulum to swing all the way to the other extreme, leaving markets at undervalued levels for several years.

The Market (S&P 500) has declined 47% (as of 9/30/02) from the peak in March of 2000; has that resulted in bargains in the stock market?

As we discussed last quarter the market appears to be quite undervalued relative to the current level of interest rates. According to Dr. Edward Yardeni of Prudential Securities, the Fed's Stock Valuation Model (a dividend discount model which compares the yield on the ten year U S Treasury bond to the projected earnings yield on the S&P 500) showed stocks to be approximately 47% undervalued as of October 4, 2002. While there are certain problems with the model (such as the reliability of earnings projections and the fact that rates might be unsustainably low), it has had a very good record in predicting market moves in the past. (Please refer to the *Summer 2002--Investment Outlook* for more on the Fed's Stock Valuation Model).

What would happen to equities if rates were to rise?

We believe that current interest rates are probably an aberration and unsustainably low. If we assume that rates were to rise it would result in the model discussed above to show stocks to be less undervalued. However, if we were to find ourselves in a rising rate environment, it would probably be the result of a strengthening economy which is typically associated with higher levels of corporate earnings. Therefore, a modest rise in rates, coupled with better earnings would likely result in higher equity prices.

Why do some experts say stocks are huge bargains while others continue to call the market way overvalued?

It is not unusual to see widely divergent opinions about the market's valuation. Price/earnings ratios based on trailing earnings are still somewhat high by historical standards. As of October 4, 2002 the S&P 500 was trading at approximately 30 times trailing earnings. But we must remember that current earnings are very depressed due to the recessionary environment. For that reason, it is necessary to also consider forward earnings or "normalized" earnings figures when considering valuations. According to Steven Leuthold of Leuthold & Company, a longtime market watcher, valuations are back to the median level of the markets over the last forty-five years and that most bear markets end near that median. Sure, stocks are not as cheap as in 1974, when single digit price/earnings ratios prevailed, but the market is the most reasonably priced it has been in years. Dividends are also becoming important to investors, as many high quality issues are yielding more than the ten year Treasury bond yield of approximately 3.65%.

How soon can one expect an upturn? Why not sell and get back in when things are better?

Valuation work and models tell us very little about the timing of a market upturn. Stocks can remain undervalued for extended time periods. There are real risks which we discussed above and those risks are the reasons the market has been declining. How they play out will determine whether a rebound is imminent or will take longer to materialize. In the near term it appears unlikely that stocks will surge given uncertainty about Iraq. However, there are many scenarios that could reduce the perceived risk (or increase it). But absent more clarity it will be hard for the stock market to rally meaningfully over the short term.

One lesson that has been taught time and time again is that it is dangerous to underestimate the ability of the stock market to surprise investors. This lesson was learned last fall after the terrorist attacks, on the heels of the Asian meltdown in 1998, and when the Gulf War started in January 1991, to give just a few examples. At present, fear and pessimism are much more apparent than greed and optimism. Clearly many negatives are already priced into stocks and a few unexpected positives could turn things around. Events in the Middle East could surprise on the upside just as they could on the downside. Being intellectually honest, even a pessimist must admit that the negative scenarios are not sure things. So the point is that with the market at a bargain level on a long-term basis, we don't want to risk missing out on the rebound simply because we can't say for sure when it will come. We recognize that it's possible that a sustained rebound might not come soon but if it does we will have missed an opportunity to profit from the undervaluation that we believe is now reflected in stock prices. A related point is that moving more heavily into defensive investments requires knowing when to increase stock allocations again. To say this is tricky is a huge understatement. As we have discussed before bear markets typically end before the economy hits bottom. The indicators that will signal that risk has declined will send stocks surging before we will be able to re-assess the risk/reward trade-offs. For example, in the month after the Gulf War began the stock market rose 17%. It was up 19% in the month after it bottomed in 1998. We're simply not confident that we can turn on a dime and catch these types of moves. So with the market clearly undervalued based on our analysis, on a long-term basis, it makes sense for long-term investors to be patient and wait for the returns that we expect will be delivered sooner or later.

What about the corporate scandals, won't people lose faith in the markets?

In 1974, the final market plunge of some 23% occurred in the fifty-five days after President Richard Nixon resigned. There have been other events and/or scandals associated with bear markets such as the failure of Equity Funding, the failure of Continental Illinois Bank and Investor Diversified Services. Each of these events seemed disastrous at the time; however, investors who maintained a long term investment horizon and discipline were rewarded with above average investment returns. Staying the course is an over-used term that implies discipline but should not be confused with complacency. We take pride in our discipline, and value philosophy, which we believe is a key to good long-term performance

What should an investor do today?

We believe that once again it is important that each investor should revisit his or her investment objectives. When addressing this, the investor should consider their risk tolerance, time horizon, liquidity needs and overall investment goals. While market risk cannot be totally eliminated, it can be reduced by allocating a portion of one's investment funds to fixed income investments and or money market funds. While we do not currently find the fixed income markets to be attractive (5 year Treasury yielding approximately 2.6%), short duration treasuries and investment grade bonds can still provide a portfolio with income and stability. In today's difficult markets it is essential that we are notified as your needs and objectives change. We would welcome the opportunity to review your investment goals and objectives at your earliest convenience. Once again, we would like to thank our clients for their support in these difficult times.

Frank G. Jolley, CFA

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