JAM JOLLEY ASSET MANAGEMENT, LLC

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*"Today's equity prices presage only moderate returns for investors. The market outperformed business for a very long period and that phenomenon had to end. A market that no more parallels business progress is likely to leave investors disappointed, particularly those relatively new to the game."*
*Warren Buffett--2002 Letter to Shareholders*

As the chart below shows, the equity markets were mixed in the first quarter of 2002 as the Dow Jones Industrial Average advanced while the S&P 500 indexed closed only fractionally higher. The Dow's advance was fueled by an improving economy and the index's exposure to some of the more cyclical sectors of the economy. The NASDAQ Composite declined once again as investors began to reassess the fundamentals and valuations of the tech sector which had a huge run up in the fourth quarter of last year. Small and mid cap stocks fared better than large, and value once again outperformed growth.

| Index | 1st Qtr 2002 |
|---|---|
| Dow Jones Industrial Avg | 4.25% |
| S&P 500 Index | .28% |
| S&P (400) Mid Cap | 6.72% |
| S&P Barra/Growth | -.79% |
| S&P Barra/Value | 1.32% |
| Value Line Index | 2.34% |
| Russell 2000 | 3.68% |
| NASDAQ Comp. | -5.42% |

The cold harsh reality of the post-bubble world is starting to hit home. Investors have experienced the worst bear market in a quarter century, and now, unlike other post-bear-market periods, they are faced with a dishearteningly low probability of achieving sustained double-digit returns from domestic equities. In the past, we've written about our outlook for lower equity returns and have encouraged our clients to adopt more reasonable expectations. While we do not want to go over our entire valuation thesis again in great detail, we do think it is worth reviewing a few significant points. Typically bear markets are followed by powerful bull markets; however, we have to point out that there are noticeable differences in our starting point in the coming new economic cycle, compared to past cycles. We think it is unlikely that we will see a similar bull market during the next economic cycle. Consider the following:

- Interest rates are much lower now than they have been at the start of past bull markets. This means that returns from bonds will be lower than in most bull markets, and, any P/E multiple-expansion driven by falling rates is likely to be more limited.
- In the last four bull markets, P/E multiple-expansion was the fuel powering most of the return. In each case multiples expanded by at least 80%! Given that multiples are now very high and interest rates very low, compared to where they were at the start of past bull markets, multiple expansion is unlikely to match prior bull market levels. We are not counting on any multiple-expansion and we believe multiple-contraction is possible.
- Earnings growth was a secondary driver in prior bull markets. Adjusting for inflation, the highest level of earnings growth during a bull market was 6.9%. And in several instances real earnings growth was almost non-existent. This underscores the low probability of earnings growth alone driving returns into double-digit territory.
- Because the dividend yield is very low now, stocks (on average) also won't get as much return from dividends as in past bull markets.

So we are sticking with our prediction that the S&P 500 is unlikely to deliver sustained double-digit returns in coming years. We are essentially now in a period of unwinding the excesses of the last bull market and in terms of returns experiencing a reversion to the mean. Of course there may be exceptions in individual years as investor optimism gets somewhat overdone.

The cold harsh reality goes beyond low expected returns. We believe there is more risk present today than has been the case in the early stages of past cycles. The risks now include:

**Valuations:** As pointed out above, at the start of most bull markets stocks were much cheaper than they are now. Inflation and economic fundamentals may ultimately justify current price levels but frankly, we don't expect that to be the case. And, increasingly, investors recognize that there are questions about earnings (i.e. Enron) that make it hard to even assess valuation levels. So at the very least we must say that valuation risk is higher than we would like to see early in a new cycle.

**Debt Levels:** Corporate and household debt is at an unprecedented level relative to GDP. These high debt levels may lead businesses to invest less and consumers to spend less while they pay down their loans. Of course it is also

possible that debt levels will not be a problem, especially if interest rates remain low. Debt levels have been in a long-term up-trend over time and alarm bells have gone off before. Debt levels were high coming out of the last recession and this contributed to the initially sluggish recovery. But there was no disastrous fall-out. The point though, is that relative to the past, debt is extremely high and this raises the risk level if things go wrong. It is important that interest rates stay relatively low.

**Current Account Deficit:** The deficit exists primarily because of the spending prowess of the U.S. consumer. Nobody will out-spend us and that has led to imports far exceeding our exports (though our export levels are very healthy). The balance-of-payments gap that is created by the deficit must be funded by foreign capital. The risk is that at some point foreign investors may not be as willing as they have been to invest in the U.S. It seems likely that at some point the collective willingness of foreign investors to hold U.S. assets will, at the very least, hit some limit. This would result in a weaker dollar, and potentially higher interest rates and pressure on the stock market, because of reduced demand from foreign investors.

**Geo-Political Risk:** The terrorist attacks last September and the alarming escalation of violence in the Middle East raise risks that had fallen off the radar. These risks include terrorist attacks that might result in jolts to the global economy, increased security expenses in the private sector, and increased military and security expenses at the federal government level. The possible impact is not only economic but also a psychological one that might reduce investors' tolerance for risk.

The net effect is that the popular indexes such as the S&P 500 and the NASDAQ Composite are likely to remain stuck in rather narrow trading ranges and unlikely to generate more than mid-single digit returns in the coming years. In addition, the combination of full valuations and above-average risk means that the potential for disappointing returns below those levels is higher than it has been in the early stages of most other economic cycles.

**So How Do We Posture Client Portfolios?**

Most investors have a strong rear-view-mirror bias when they invest. That's why small-cap stock funds were so popular in the early 1980s at the tail end of a massive run for small-cap stocks. And that's why foreign stock funds were hot in the early 1990s, after a huge run for foreign stocks. And that's why value investing was so heavily promoted in the mid-1990s after value investing had outperformed over 20 years. And, more recently, that is why growth stock funds were the rage in 2000 even after huge returns resulted in off-the-charts valuations. In each case the hot asset class went on to drastically underperform. Rear-view-mirror investing is a poor strategy. Periods of huge outperformance can't last forever for any asset class. The good news is that once again many sectors and companies will become mispriced by the markets and trade at significant discounts to their intrinsic value. We will attempt to take advantage of the gap between the market value and our estimated intrinsic value. That is what value investing is all about.

We believe that we will have to be flexible in our thinking towards stocks and continue to be somewhat contrarian to outperform over the coming year. A strict buy discipline and sell discipline will become even more important going forward, especially if one is to assume that the major indexes will make little progress over the near term. Just recently, we liquidated two of our holdings Federal Express and Media General. While we continue to like both companies, we thought the stock prices of both had gotten ahead of the current fundamentals. Currently opportunities are beginning to unfold in sectors such as pharmaceuticals, with many of the stocks trading near three year lows. Opportunities will likely appear again in the technology sector as many of the momentum investors of yesterday finally capitulate and sell their shares with no regard for valuation. So while the indexes are richly priced, we continue to believe that the markets will provide opportunities that a disciplined value manager such as Jolley Asset Management will be able to take advantage of. In coming months we may hold cash positions that are somewhat higher than what we consider to be normal, however, we would rather hold cash (money market) and wait for the right opportunity rather than make an inopportune commitment of our client's funds.

Winston Churchill said "a pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." Despite our belief that returns will be lower over the next few years than they have been, on average, over the last ten, we see opportunities and we believe that with a disciplined value approach acceptable returns can be attained. This will require discipline as well as flexibility. We believe that returns will be based on stock selection rather than an overall advance in equity prices. It is our belief that our multi-cap value approach will serve our clients well in this type of environment. We hope to make volatility our friend rather than foe by using such periods as an opportunity to sell or buy at a more attractive level. In summary, we believe that our strengths—our discipline and value oriented philosophy—will continue to be rewarded in this environment. As always, we are committed to staying focused and doing all we can to achieve investment success on your behalf. ***Frank G. Jolley, CFA***

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