JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook — Volume 1, Issue 17 • Summer 2002

"We have found that many of the crooks look like crooks. They are usually people that tell you things that are too good to be true. They have a smell about them."
Warren Buffett--May 2002

As the chart below shows, the second quarter of 2002 closed out a devastating first half of the year for equity investors. The S&P 500 losses for the second quarter (-13.39%) and first half (-13.15%) were the steepest on record since 1970. While "value" continued to outperform their "growth" counterparts; the month of June was particularly difficult for all stocks, leaving no place for the equity investor to hide.

Index	2nd Qtr 2002	YTD 2002
DJIA	-10.71%	-6.91%
S&P 500	-13.39%	-13.15%
S&P Mid Cap	-9.31%	-3.21%
S&P Barra/Growth	-16.25%	-16.92%
S&P Barra/Value	-10.64%	-9.45%
Value Line	-14.23%	-12.23%
NASDAQ Comp.	-20.61%	-24.91%

It has been more than 60 years since the U.S. stock market experienced three consecutive negative calendar years. With the S&P 500 down 13.15% on the year through June, it will take a 15.1% increase over the next six months to avoid that fate (in terms of the math, remember that it takes a 100% gain to offset a 50% loss—which makes outperforming in a down market such an important pre-requisite to good long-term returns). We've managed to outperform our benchmarks by a substantial margin during the bear market but we can only feel so good about a relative victory in the face of a weak absolute-return environment. Like you, we're more than ready for something better and we badly want to believe that the stock market is set up for a great run. Those of you who we've worked with for a long time know that we are contrarian in nature, often trying to take advantage of market overreactions. In the past we have often fared well as buyers of equities in the face of significant price declines. After three consecutive years of declines in the major averages, you would think we would be set up for a huge bull market. So how does this decline stack up as a buying opportunity?

Positives

While it is always difficult to predict the timing of a market turnaround, it is worth noting that history is on our side. The quarter just ended was one of the ten worst in terms of quarterly returns since 1946. In each of the quarters that followed the ten worst declines of the last fifty years, the stock market has staged a solid recovery, with an average recovery of 8%. Furthermore, cash on the sidelines as a percent of stock market value is near the highest level in over twenty years according to Ned Davis Research. As of May 31, 2002, this ratio was 22.6%; the twenty-year peak was in 1982 at about 23% just before the start of a major bull move. The average cash over the past ten years has been approximately 10%. The current level of cash on the sidelines represents buying power to fuel the market higher and also suggests that investors have already moved to a defensive posture.

With the S&P 500 currently trading below 1000, valuations currently look more compelling than they have for most of the past five years. According to Edward Yardeni of Prudential Securities, the "Fed Stock Valuation Model", currently shows that stocks are about 17% undervalued. Other than a brief period after September 11, 2001, this represents the first time this indicator has flashed "'undervalued" since the Russian debt crisis of 1998. As we have discussed before, the model is widely followed and essentially compares the yield on the ten year Treasury note and the earnings yield on the S&P 500, with the general idea that the expected return of the two competing returns should be more or less the same. As can be seen from the chart below, the model has a pretty good track record at calling the market. There are potential problems with the model that should be pointed out. First the earnings yield is based on earnings estimates, which are almost always too high. Also in light of recent accounting scandals, one would have to question the "quality of earnings". The other potential pitfall of the model is that any blip up in interest rates would potentially wipe out the undervaluation.

Date	Fed Model	S&P 500 three months later
8/87	34% Overvalued	Down 30%
10/98	10% Undervalued	Up 16%
5/99	37% Overvalued	Up 1%
3/00	52% Overvalued	Down 4%
9/01	10% Undervalued	Up 10%
6/02	17% Undervalued	?

Source: Prudential Securities

With stocks taking a beating over the past quarter, it has been easy to lose sight of the fact that the economy has actually been doing pretty well. While we would not expect to see the economy continue its 6.1% GDP growth of the first quarter, we would expect to see the cyclical rebound continue with many of the "old economy" industries leading the way. It is also worth noting that the near term inflation risk remains quite low. Although there is some risk to some bump up in interest rates over the intermediate term, we believe the Fed is likely to stay in an accommodative mode for the stock market for the near term.

Negatives

In looking backward to assess the potential for another bull market, it is crucial to realize that the huge bull run of the 1980s and '90s was largely driven by falling interest rates—a scenario that is unlikely to be repeated. The huge P/E-multiple expansion during those two decades was mathematically tied to the big drop in interest rates, which was a massive tail wind for the stock market. But now, with rates low there may be no tail wind at all. We can hope for a period of rate stability (no wind) and that is quite possible. But it is also quite possible that there will be a slight headwind of rising rates that could cause multiples to contract and become a negative for stock prices. So, despite the savage decline of the last few months, which comes on the heels of a prolonged bear market, we are not optimistic that stocks are set up for a long period of double digit returns.

A related issue is the level of earnings. Just how much financial shenanigans have been going on? When we assess valuations we must use an earnings number. Is the number valid or is it in the process of being restated downward? We believe there will be more surprises, but it is unlikely that, at this point, earnings for the overall market are materially overstated given the huge earnings decline that has already occurred. Standard & Poor's has recently begun to report operating earnings after adjusting for stock options to be treated as an expense item. Moves such as this will result in better "earnings quality" going forward, but over the near term this transition to more transparency could prove to be troublesome for investor confidence.

The headlines with regards to "corporate governance" issues and accounting scandals are a factor that could contribute to a general lack of investor confidence that could chip away at the "equity culture" and possibly lead to lower P/E multiples. While we would point out that we believe that the onslaught of troubling headlines on corporate management misdeeds will eventually result in significant positive behavioral changes, in the near term it destroys investor confidence. Regulation, prosecutions, embarrassments and investors generally paying attention (they weren't during the bubble) will all drive a change in behavior and make the corporate governance issue temporary. Regardless of our expectation that corporate governance will improve; the short term "headline risk" remains with us.

Foreigners invested $386 billion into U.S. stocks in the three years-ended 2001. This year the pace of flows has dropped by approximately 50%. With the U.S. image somewhat tarnished relative to other markets and foreign investors already heavily invested in the U.S., there is the risk that foreign flows will continue to be scaled back. We don't know if this will happen but in our opinion it is a high enough probability to be worthy of mention. To put the importance of foreign flows into perspective, foreign investment in U.S. equities wasn't far off of the $490 billion of flows into U.S. equity funds over the same three-year period.

Then there is the terrorism wildcard. Many potential terrorist acts would probably not have a far-reaching economic impact. However, if the worst-case scenarios involving weapons of mass destruction come to pass a severe economic impact could be felt. This is not priced into the market (nor should it be—it is far too uncertain). Worst-case scenarios rarely happen and we've always tended to discount them. But at the very least the risk will lead to more defense and homeland security spending. These are not productivity enhancing activities.

Conclusion

In summary, this has been one of the most difficult investment environments that we've experienced. While we have repeatedly warned that the equity markets were overvalued, it doesn't make it any easier now that the "bear market" is in full force. While we still don't find stocks (the major indexes) to be statistically cheap, we do believe there are opportunities in certain sectors and companies that investors can take advantage of. In this difficult investing environment, we believe there are several things that an investor can do to help increase the odds of investment success:

1) Make sure that you can live with the risk assumptions underlying the portfolio strategy that we (or your other advisors) are implementing. The appropriate strategy should balance your risk tolerance, time horizon and overall investment objectives. If you would like to review your strategy and its appropriateness, please let us know.

2) Maintain reasonable return expectations. The days of easy double-digit returns are over. Single digit returns in a low-inflation environment can still compound out to surprisingly strong wealth creation over a period of years.

3) Remember there is no free lunch in investing. Achieving decent long-term returns requires a willingness to take some short-term risk. Staying the course takes great discipline.

Going forward we believe that we are continuing a transition to a more rational investing environment that will be characterized by a return to basic fundamentals. Value and discipline will be rewarded, as will honesty, integrity, and accountability. These are traits we have never lost sight of and any environment that emphasizes these is one that we believe plays to our strengths.

Frank G. Jolley, CFA

JAM 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