JOLLEY ASSET MANAGEMENT, LLC

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"Wall Street people learn nothing and forget everything."

Benjamin Graham

Current Scenario

1) We have the terrorists on the run and Osama Bin Laden will likely soon get what he deserves. 2) The average economic recession typically lasts approximately eighteen months and we are now approximately halfway through that. 3) Stocks have an excellent history of forecasting the economy; and typically begin to advance some six to nine months ahead of the recovery. 4) The "bear market" decline of 38% (from the April 2000 peak to September 21st intra-day low) has exceeded the average "bear market" decline (since 1950 as measured by the S&P 500) of around 30%. 5) In the fourth quarter, the equity markets climbed a wall of worry, discounting the worst and looking for a stronger recovery towards the second half of 2002. For the quarter just ended, the Dow Jones Industrial and S&P 500 Index advanced by 13.8% and 10.7% respectively. 6) While the year still ended decisively negative (see chart below), the Federal Reserve's medicine of eleven interest rate cuts in 2001 appear to finally be working. 7) Not since 1938-1941 have equity investors seen three down years in a row.

In many ways, it looks and feels like a new bull market!

Index	4th Qtr 2001	2001
DJIA	13.8%	-5.3%
S&P 500	10.7%	-11.9%
S&P Mid Cap	18.0%	-0.6%
S&P Barra/Growth	13.1%	-12.7%
S&P Barra/Value	8.0%	-11.7%
Value Line	18.8%	-6.1%
NASDAQ Comp.	30.2%	-21.0%

This scenario, that the bottom is now in, and stocks are off to the races, again is being aggressively promoted by Wall Street, the brokerage community and CNBC. While we very much would like to join in on the fun and accept the above scenario; our optimism is muted by one important factor. That factor is "valuation". At most "bear market" bottoms, stocks have typically been hit hard by declining earnings and traded at compelling valuation levels. As the second chart shows, that has not happened in this cycle. In fact, stocks are almost twice as expensive today as at the lows of all previous bear markets since 1950 and actually near or above the levels reached at most prior bull market peaks. We will attempt to explain why stocks are not cheap even though we just wrapped up one of the worst two year periods for stocks in almost three decades.

Year	P/E at Market Lows
1957	12
1962	15
1966	13
1970	12
1974	6
1982	7
1987	13
1990	14
Average	11.5
2001 (at lows)	22-26*

Source: David L. Babson & Co. *26x operating--22x GAAP earnings

Part of the explanation for the high price/earnings ratio is clearly related to the weak economy and weak corporate earnings. In 2001, S&P profits (operating profits) are estimated to be down approximately 27%. When the denominator (E=Earnings) declines at a faster rate than numerator (P=Price), the net result is a higher P/E multiple. We should point out, however, that earnings typically do falter during recessions and bear market phases, with many cyclical areas of the economy often showing losses. That is essentially why one must look at the price/earnings ratio based on future earnings, especially during recessionary periods. It is our expectation that earnings will begin to recover in the second half of 2002 and S&P earnings estimates of around $50 (while below consensus); seem to be a realistic expectation. This would result in a price/earnings ratio of approximately 23 times the 2002 estimates. While an improvement from current levels, that is still significantly above the historical price to earnings ratio which is in the midteens. An even greater risk, is that the earnings recovery fails to materialize in the second half of 2002, leaving stocks grossly overvalued.

It is important to note that generally, low interest rates and low inflation support higher price/earnings multiples. In fact, based of the Federal Reserve valuation model, with the 5-year U S Treasury bond currently yielding 4.4%, stocks would be fairly valued at approximately 23 times earnings.

While a rough yardstick, stocks appear to be fairly valued based on this model (assuming an earnings recovery). However, the lower interest rate environment does not assure us that price/earnings multiples will remain at these lofty levels. As can be seen in the chart below, the last two times interest rates were at these levels, stocks sold at fourteen and seventeen times earnings. So while history is far from a perfect measuring stick, assuming a best case scenario (economic recovery) stocks appear fairly valued. Essentially, much of the near term upside potential for stocks has been eliminated with the strong rally since September 21st.

Time Period	Yield-Moody's Aaa Corp Bonds	Stock Valuation P/E Dow Jones
1920-1929	4.8%	14
1940-1955	2.8%	11
1956-1967	4.4%	17
1968-1979	8.7%	12
1980-1985	12.7%	11
1986-1994	8.8%	16
1995-2000	7.2%	20
Current	4.5%	21

Source: Valueline (1930-1940 omitted due to distortions of Depression)

Given that stocks are not cheap, what should an investor be looking for with regards to expected returns? Over long periods of time stock prices are essentially a function of two basic components 1) corporate earnings and 2) price/earnings multiples. Stock returns are a function of earnings growth +(-) multiple expansion (or contraction) and 3) dividend income. Assuming that corporate earnings track the nominal GDP growth of 4-5% and dividends of 1.3% (current yield on S&P) expected returns would amount to 5.3% to 6.3% over an extended period of time. This projected return assumes a constant price/earnings ratio. In the current interest rate environment price/earnings ratios appear reasonable. We would point out, however, that any acceleration in the price/earnings multiple would be the result of a re-inflating of the bubble and would be unsustainable over the long term (in our opinion). Simply put, we do not think it is likely that we will see higher price/earnings multiples going forward.

As can be seen in the chart below, in the period from 1982 through 2000, profit growth plus the dividend yield totaled approximately 10%. The market during that period gave you about a 15.7% total return (multiple expansion from under 10 to the mid twenties). Essentially, you got an extra 5.7 percentage points of reward in relation to how much earnings were increasing. Note that almost all of the acceleration in equity returns since 1981 has come from the sharp rise in the price/earnings ratios. If one looks ahead and makes the optimistic assumption that today's high price/earnings ratios could be maintained, stock returns will approximate the earnings growth + dividend yield (approximately 6.3%) Moreover, if price/earnings ratios work their way back towards historical averages, the total return for stocks will be somewhat below this figure as declining multiples offset part of the forces of earnings and dividend growth. This is essentially what happened in the mid-1970's as price/earnings ratios drifted down to the ten to eleven range from the twenty range. Stocks remained in a trading range while that downshift occurred.

Total Returns on Large Capitalization Stocks.

Time Period	Earnings Growth	Dividends	Earnings + Dividends	P/E Increase	Total Return
1926-1981	4.3%	4.8%	9.1%	0	9.1%
1982-2000	6.6%	3.4%	10%	5.7	15.7%

Sources: Ibbotson Assoc, Sanford Bernstein

Predicting equity returns is a "risky" proposition much like market timing. We believe both are futile exercises. However, we do believe it is important to plan using reasonable expectations and assumptions. We are braced for a 'rational' environment not a repeat of the "irrational exuberance" of the late 1990's. We will continue to focus on valuation parameters and take advantage of any downturn in the markets and/or individual securities. It is our belief that our discipline and value-oriented philosophy will be just as important going forward as it has been these past two years.

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