JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 22 • Fall 2003

"Monetary Policy acts a little like vodka—you think it's not working, and then it sneaks up on you."
Robert McTeer, Federal Reserve Bank-Dallas

The equity markets continued their winning ways in the third quarter as investors became more confident in the economy and a corporate earnings recovery. While all the major equity indexes were up for the quarter, the NASDAQ and Russell 2000 (smaller capitalization stocks) powered higher with returns of 10.11% and 8.77%, respectively. While returns on the S&P 500 and Dow Jones Industrial Average lagged, they were up a respectable 2.65% and 3.76%, respectively. Growth stocks as measured by the Russell 1000 Growth Index, beat out value stocks (Russell 1000 Value) for the quarter ended September 30th.

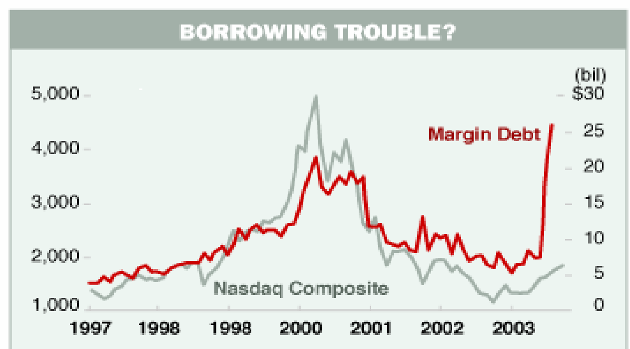
Index	3rd Qtr 2003	YTD 2003
DJIA	3.76%	13.12%
S&P 500	2.65%	14.71%
S&P Mid Cap	6.58%	19.80%
Russell 1000/Growth	3.91%	17.51%
Russell 1000/Value	2.06%	13.87%
Russell 2000	8.77%	27.30%
NASDAQ Comp.	10.11%	33.80%

Liquidity from refinancings (consumer and corporate), an accommodative Federal Reserve Board and tax cuts has fueled an increase in the money supply , which has provided the impetus for the equity market's advance. With interest rates hovering near all time lows, there clearly remain few alternatives for investors. Couple this with the fact that corporate earnings have rebounded nicely and we have all the ingredients of a "bull market".

Déjà vu?

In our "*Investment Outlook—Winter 2003*" (1/15/03), we stated, "While we do not expect 2003 to be a huge up year for equities, we do believe the risk/reward is becoming more compelling." Clearly we have been surprised by the magnitude of the move off the bottom, especially in the smaller cap, lower quality names. What is more troubling to us is the fact that speculative strategies and day-trading are once again all the rage. Didn't people learn anything in the last "bubble"? As Jeffery Saut, Chief Investment Officer of Raymond James put it succinctly, "The companies that have run the most are the ones with the least (to offer). Speculation is back." The most active lists have been dominated with low priced issues such as JDS Uniphase (currently around $3.84 down from over $142 per share in 2000), Lucent Technologies, Nortel, and Sun Microsystems to name a few. Doesn't this all sound familiar—investors buying highly speculative stocks (many on margin) expecting unrealistic returns. According to Nigel Tupper, Global Strategist at Merrill Lynch, "The current premium for lower quality stocks is at six-year highs in the United States and near record levels in Europe." Floyd Norris of the New York Times perhaps put it best in saying "As this bull market nears its first birthday, its defining characteristic is that bad stocks are great".

The September 22nd issue of *Barron's Magazine* ran a chart provided by Alan Newman, the editor of *CrossCurrents* showing the movement in the NASDAQ Composite and margin debt extended by NASD firms from 1997 through July of this year. As you can see from the chart below, the explosion of margin debt provides some insight as to why we have seen the massive move in the NASDAQ and the speculative nature of the markets. As Alan Newman stated, "The greatest stock market mania is still very much in progress".



Source: CrossCurrents—Alan Newman

It is perplexing to us as to why the investing public has once again taken on a speculative tone in their investment strategies. Perhaps Richard Bernstein, Chief Strategist at Merrill Lynch summed it up best when he published the following from a keynote speech from Dr. Vernon Smith—2002 Nobel Prize winner in Economics.

"Dr. Smith is perhaps best known for his work in experimental economics related to investment bubbles. He has shown that new participants in his experiments consistently produce a bubble and a subsequent crash even when the value of the traded asset is well known by all participants. After experiencing the first bubble in the first round of trading, participants then trade during a second session. Again they produce a bubble and a crash, but second version is smaller than the first. He subsequently asks participants why they took part in the second bubble given their experience with the first. Their response, according to Dr. Smith is uniform. Participants thought they could make money in the rally, but would be able to get out in time to avoid losses."

Below we have summarized our thoughts on three companies that we have been adding to client portfolios in recent months. We believe the risk/return profile on each is attractive and each either pays or we believe will implement a meaningful dividend in the coming year.

Automatic Data Processing--$35.85 (9/30/03) 1.3% yield

Automatic Data Processing (ADP) is the nation's largest payroll and tax filing processor. The stock is down from over $65 per share in December 2000. An improving economy should eventually boost company payrolls, boosting returns from employee services. Another positive is the fact that 25% of revenues come from brokerage services (back-office operations), which should do better with stronger financial markets. As of 12/31/02 the balance sheet of ADP showed $5.1 billion in equity versus only $90 million in long term debt. Earnings are estimated at approximately $1.60/share for 2004.

Boeing--$34.33 (9/30/03) 2.0% yield

Boeing (BA) is the leading manufacturer of commercial jet aircraft and also is a major defense contractor. BA's stock price has been cut in half since December 2000. While a recovery in "jetliner demand" is not likely until 2005, the defense part of the business should provide the company with a stable source of revenues over next couple of years. Boeing is estimated to earn approximately $1.80 per share in 2004, up from a depressed level of $1.00 per share being estimated for 2003.

Safeway--$22.94 (9/30/03) 0.0% yield

Safeway (SWY) operates about 1700 supermarkets in the United States. While these have been tough times for supermarket chains, with a struggling economy and competitive pressures (Wal-Mart), trends have recently begun to show signs of stabilization. Merrill Lynch has estimated that SWY will generate approximately $800 million to $1 billion in free cash flow this year and expects the company to consider implementation of a cash dividend. Merrill pointed out that if SWY decided to pay out approximately 60% of its free cash flow, the theoretical dividend would be over 4%. Safeway trades at under 10 times its 2004 estimate of $2.38.

Summary

It is our belief that investing is a serious endeavor, not a game that should hinge on the comments of a CNBC commentator. We have always invested with a cautious bent, erring on the side of conservatism. That will not change. The recent upward move in the market has made finding attractive issues more difficult, but not impossible. As was the case in 1999 and 2000 many investors (speculators, day-traders, etc.) are becoming enamored with overvalued, momentum stocks, ignoring areas of the markets that are reasonably valued. We believe these speculative momentum strategies will end badly. We remain committed to owning what we believe to be high quality, undervalued equities for the long term. While value investing will definitely have its setbacks, we believe any such setback will be a "temporary" loss of capital versus a "permanent" loss of capital that often occurs in speculative investment strategies.

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