

“Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us.”
Warren Buffett 2/21/03

It was a difficult first quarter, with virtually every equity asset class showing losses. Uncertainty over the prospect of war with Iraq was a drag on the markets through most of the first two months. While the markets rallied during the first week of the invasion of Iraq, they faded late in the quarter as investors became uneasy over the progress of the war. Most indexes showed losses in the single digits, with large-caps outperforming small caps, and growth stocks—led by the NASDAQ—outstripping value stocks across the market-cap spectrum (see chart below).

Index	1st Qtr 2003	YTD 2003
DJIA	-3.65%	-3.65%
S&P 500	-3.15%	-3.15%
S&P Mid Cap	-4.44%	-4.44%
Russell 1000/Growth	-1.07%	-1.07%
Russell 1000/Value	-4.86%	-4.86%
Value Line	-7.39%	-7.39%
NASDAQ Comp.	.42%	.42%

It's no secret that investor psychology has a material impact on financial market volatility over the short run. Many portfolio managers are fond of pointing out that the huge volatility in the prices of individual stocks over any given year doesn't reflect the actual change in value of the underlying business. Stock prices are volatile; business values are much less so. Stock price volatility does reflect change in what investors are willing to pay for a share of those businesses. What impacts these perceptions of value? In some cases there are developments that are material to the fundamental operations of the companies. But more often it is emotion that impacts those perceptions. When investors are driven by greed they tend to downplay risk. In periods of extreme greed many are incapable of acknowledging any risk. A glass filled halfway is not just seen as half full, it is seen as full. Conversely when investors are driven by fear, risks are overblown and the positives are downplayed. The glass is beyond half empty and is seen as nearly empty.

The last five years have been among the most amazing in financial market history. Not only have we witnessed a greed-driven "bubble" environment on par with any in history, we've also watched its collapse. It is important to understand that the bubble was not simply a reflection of overvalued stocks. The greed that inflated stock prices permeated the economy in a variety of ways. Because rational thinking was not in evidence as the late 1990s

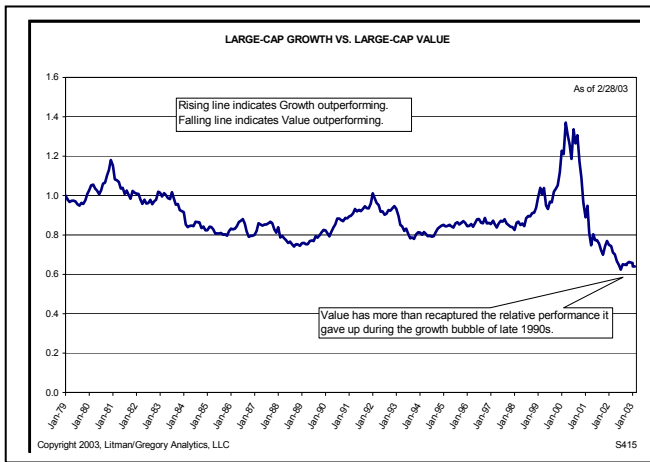
moved toward the new millennium, it is not surprising that there were other excesses that developed and are also now being addressed. Corporate governance abuses, debt levels and the excess capacity present in many segments of the global economy are in various stages of reversal.

As we've watched this period unfold, the evolution of investor psychology has been fascinating. Emotion is alive and well and fueled not just by the financial media, but also by the Internet. Unsubstantiated stories, rumors and analyses from sources lacking in credibility spread like wildfire. One of the most surprising developments is the psychological swings of people who we consider to be very financially sophisticated. Most investor's were not concerned about risk in early 2000 but instead were more concerned about keeping pace (relative performance) with or beating the market averages in a wild bull market. Now these same investors are concerned about risk (absolute performance) and are interested in reducing equity exposure. Perhaps their desire to reduce equity exposure will prove to be wise, but the quality of their risk assessment must be questioned given the fact that at the start of the bear market (when risk was highest) they were bullish, and they have now become risk averse after the stock market has lost almost 50% of its value and the NASDAQ is down about 80%.

In light of the events of the last few years this is a good time for all investors to be intellectually honest by thinking back to their view of risk and return in early 2000. If views were detached from reality back then, what does that suggest about the wisdom of trusting an emotional point of view today? This is exactly why we believe it is so important for investment decisions to be made in the framework of a process that is consistently applied and is as far removed from emotion as possible.

Growth vs. Value

Three years ago we discussed that the bifurcated market (growth expensive/value cheap) had created some of the best opportunities for value oriented investors in recent years. At that time the S&P 500 was trading at approximately 24 times forward earnings, while the median stock in the S&P was trading at a more reasonable 13.5 times. The damage incurred by the bear market of the past three years has, in our view, resulted in a market that no longer favors "growth" or "value". It is quite possible that the "value" stock universe may continue to outperform the "growth" stock universe until "value" is significantly overvalued on a relative basis. This has happened in the past after growth stock over-exuberance has been unwound. However, there have not been many periods to study and we are not willing to predict that "value" will become overvalued relative to "growth".



After massive underperformance during the bubble run-up, value stocks dominated from March of 2000 through the first half of 2002, with the only exception being the fourth quarter of 2001. From July 2002 through February 2003, relative performance has been almost a dead heat (in the context of an overall market decline) with each style group taking a turn outperforming for short runs of a couple of months (based on the Russell indexes). In the small-cap world growth has slightly outperformed value since July of 2002.

It is also worth noting that since delivering positive returns during most of the first couple of years of the bear market, value has been hit hard over the last year. Over the past year (through February) both small and large-cap value stocks are down close to 20% on average (based on Russell benchmarks).

Since March of 2000, large-cap value stocks have far more than reversed the four years of prior growth out performance. In the small-cap world the same general performance patterns have been in place. The value out performance among small-caps eliminated all of the huge performance advantage that small-cap growth stocks had achieved over value stocks in 1999. It is worth noting that there have been sizable discrepancies over some of this time period in the most widely used growth and value benchmarks. The BARRA and Russell small-cap indexes in particular have had several periods during the last few years where their returns were significantly different. We believe the S&P/BARRA methodology has led to a "growthier" value index and therefore we do not believe these benchmarks have always accurately reflected the performance differential between the growth and value

universes. On the other hand the Russell 2000 Growth index has had horrible performance over the long run, significantly lagging other small-cap growth benchmarks and the vast majority of actively managed small-cap growth mutual funds.

We believe the coming years may favor portfolio managers who are somewhat eclectic and not slaves to a "Morningstar Style Box". In an environment where neither "growth" nor "value" is advantageously priced, we believe that the key to returns (both relative and absolute), will be good "bottom-up" stock picking. As we have stated in the past, we are more focused on the underlying business and its valuation, rather than whether the company falls into a small, mid-cap, or large-cap category. Additionally, we believe that "value" can be found in many different types of companies ranging from "cyclical businesses" to broken-down "growth" companies. *Barron's Magazine* recently addressed this issue and the dilemma that many mutual fund companies have found themselves in. The mandate has been: "Stick to your index, and your style box. Then regardless of whether you've made or lost money, you've done your job—relatively speaking." Many of these "so called" rules that managers remain fully invested and conform to narrowly defined investment styles, largely originated with the pension fund industry, allowing a consultant to perform overall asset allocation, with the manager simply focusing on a slice of the overall portfolio. It has been my opinion that in some situations, the S&P 500 Investment committee was managing most of the mutual funds rather than the actual portfolio manager. Today, forward thinking investment consultants are beginning to challenge the conventional wisdom of "style purity" and rigid asset allocation schemes.

We like to think of ourselves as conservative, multi-cap value investors. Does that mean we will never own a "growth company"? Absolutely not. We would be perfectly content if all of our portfolios were comprised of steady growth companies; however, we would point out that we are not willing to pay just any price for that growth. We would like nothing better than to own growth companies at "value" prices. In recent months we have purchased shares of Merck and Costco Wholesale. These were both thought of as growth stocks a couple of years back; now we believe they are still growth companies, but we were able to purchase them at what we believe to be attractive valuations. In essence, we have not changed our investment process on analyzing these businesses, what has changed is the valuation the market placed on these companies.

Looking ahead not much has changed since last quarter. We currently believe equity valuations are reasonable (cheap based on dividend discount models, fairly priced based on price/earnings, price/cash flow, etc), however, concerns over war and geo-political issues have taken over in the short term. The progress in Iraq should allow investors to once again focus on the economy, where we would expect a modest second half economic recovery. While we understand that these are trying times for investors, we believe our discipline, patience, flexibility and value oriented philosophy will continue to serve our clients well over the coming year.

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