JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 21 • Summer 2003**

> *"I don't care if someone else makes money faster. The idea of caring if someone is making money faster is one of the deadly sins."* Charles Munger—May 2003

What a difference a quarter makes! The powerful second-quarter rebound more than offset a tough first quarter, rewarding investors with sizable returns during the first six months of 2003. Three months ago we wrote about all the economic and geopolitical negatives. But after that rather depressing discourse we also wrote "…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." Many times in the past we've written that investors should never underestimate the ability of the stock market to surprise. Our respect for the stock market's ability to humble investors over the short-term is part of the reason why we put so much faith in our disciplined, value oriented approach, and put little faith in market timing. So, despite economic and geopolitical worries, three months ago we believed that sentiment had become too negative, especially in light of the fact that the S&P 500 had lost nearly 50% and NASDAQ 80% from peak to trough. For this reason, despite our big-picture worries we believed the odds were high that we would be rewarded either sooner or later for maintaining equity exposure. In essence, we relied on that which we could confidently assess (valuations) and were influenced less by factors that we could less confidently assess (geopolitics and the timing and strength of an economic turnaround). This allowed us to resist the temptation to get more defensive. Now, three months later, the returns from equity asset classes have been impressive.

Index	2nd Qtr 2003	YTD 2003
DJIA	13.11%	9.02%
S&P 500	15.39%	11.75%
S&P Mid Cap	17.62%	12.40%
Russell 1000/Growth	14.31%	13.09%
Russell 1000/Value	17.27%	11.57%
Value Line	22.36%	13.31%
NASDAQ Comp.	21.00%	21.51%

It is worth addressing the question of why equity-type assets started taking off before the Iraq war even started (in mid-March) and have continued to rise despite continued economic uncertainty. There are three reasons: 1) The stock market prices in expectations about the future. In times of fear or greed those expectations are often exaggerated, becoming overly optimistic or overly pessimistic. That leads to exaggerated actions in the form of excessive selling or buying. In March, investors were overly pessimistic, resulting in depressed prices for many financial assets. This dynamic is why it is usually safest to buy when fear is high and why it often pays to be more cautious when investors are ignoring risk. 2) The economy continues to struggle, however it is not getting worse. Moreover, there is an increasing amount of stimulus with exceptionally low interest rates, a falling dollar (resulting in less competition from imports) and the tax cut. Areas of the economy are showing strength (housing) and the business sector has been able to take advantage of very low interest rates to refinance debt and lower debt service. 3) Though great uncertainty about the post-war period remains, the Iraq-war disaster scenarios did not come to pass.

This all underscores once again the need to be forward-looking in assessing financial markets, rather than backward-looking or fixated on today's worries. And a critical part of the analysis is assessing what the financial markets are pricing in (or "discounting"). Sometimes the markets price in nirvana and sometimes they price in the end of the world. Today, for the first time in years they seem to be doing a reasonably good job of pricing in reality.

We always get nervous when financial asset prices move sharply higher over a short time period. Contributing to our discomfort these days is the bullishness of financial advisors and investment strategists. According to several polls of both groups, optimism is higher than it's been at any time since 1987. Huge optimism is usually a bad sign because it suggests that if investors have acted on their optimism, stock prices will have been bid too high. However, investment sentiment is just one factor and a temporary one at that, so it rarely factors into our investment-decision-making process. To reiterate, most important is the valuation picture. The bad news is that equities no longer appear to be huge bargains. The good news is that, when compared to the fixed income market (bonds), equities appear to be the more attractive asset class. According to Merrill Lynch, the proportion (approximately 18%) of S&P 500 companies that offer yields greater than that of the 10-year Treasury bond has hit a seventeen year high. With this in mind, we find it strange that S&P 500 stocks that do not pay dividends are outperforming stocks in the S&P 500 with the highest dividend yield by approximately 20% so far this year. Furthermore, stocks with dividend yields lower than 10-year Treasuries are outpacing those stocks with dividend yields greater than 10-year Treasuries by approximately 8% so far in 2003. Going forward, we believe investors will refocus on dividends especially in light of the new dividend tax rate cut.

What Could Go Wrong

With equity asset classes at what we believe to be fair value, it makes sense to review what could go wrong and end the current equity rally. We've identified several risks over the past year. While some of these risks appear to have subsided, they continue as wild-cards that could derail the equity markets rise.

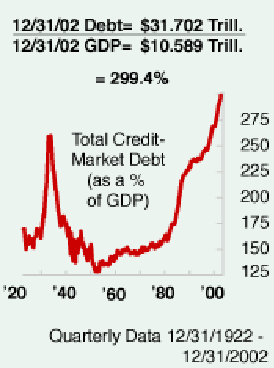
- Structural risks including debt levels and the sizable U.S. dependence on foreign capital
- Deflation, which could be a by-product of high debt level and overcapacity
- Inflation, which could eventually be ignited by attempts to fight deflation
- Geopolitical risks including terrorism.

Debt levels are still high but on the corporate side stresses have eased considerably. That's because interest rates have dropped significantly for less-than-creditworthy borrowers. This has allowed many highly indebted companies to refinance their debt, significantly increasing their cash flow. On the household side, refinancings have continued and hopefully this has helped stabilize and potentially reduce debt service (the most recent debt service data we have is as of 3/31). However, household debt (credit cards, mortgage, etc.) has continued to accelerate, growing by over 10% in the 12 months ended 5/31. The overall growth rate of debt is higher than it has been in over ten years and this increase may offset some or all of the benefit of lower interest rates. (Some of this is probably explained by the increase in first-time home buyers.) As far as the current account deficit goes, it is still huge, but the declining dollar should begin to have an impact. The good news is that the dollar has dropped substantially without a crisis or major dislocations. Dollar risk continues but with a big move already behind us the risks are somewhat less than they were.

THE DEBT DRAG

Despite record stimulus, economic growth remains weak, a phenomenon only seen two other times: following 1929 in the U.S. and 1989 in Japan. High debt levels may explain it. With debt steadily growing since 1933 to nearly $32 trillion today, the amount of growth produced in gross domestic product has been diminishing.

Date	Debt (bil)	% Gain	GDP (bil)	% Gain
1933	$146.6	–	$56.4	–
1962	887.6	505%	594.4	954%
1981	5,269.4	494	3,203.1	439
2002	31,702.2	502	10,588.8	231



Source: Ned Davis Research

Deflation risk remains but we are less concerned than we were last year. Though some data continue to suggest deflation is a risk, the Fed has made it clear that it will not take chances and will err on the side of too much inflation. It has a variety of tools at its disposal but it may be able to accomplish much of the job by simply stating what it "might" do. For example, there has been talk of buying Treasury bonds—this talk has no doubt helped keep bond prices high and interest rates (including mortgage rates) low. To date there has been no need to actually buy bonds because the threat of doing so has impacted the market's pricing of those bonds as if some of the buying had actually occurred. Aside from taking comfort in the Fed's focus, the economy remains on shaky footing but there are signs of stabilization in the labor market and the manufacturing sector. These signs are hardly conclusive but marginal improvement along with the increased fiscal stimulus soon to kick in suggest more reason to be optimistic than pessimistic.

Inflation risks are not significant in the near term. Even if deflation is avoided as seems quite likely, the risk will probably be around for a while, very probably into next year. However, the monetary and fiscal stimulus that is in place could ultimately overshoot the target and result in a spike in inflation. Though not a near-term concern it is something we think about as we think through return expectations over the next three to five years.

Geopolitical risks remain, though the stress level has declined. So far the fear that a U.S. attack on Iraq would increase the risk of terrorism in the U.S. has not come to pass, but it remains a huge unknown. Most terrorist acts have little direct impact on broad economic behavior and thus affect financial markets only temporarily. However, the possibility exists for terrorist acts that could have real economic consequences, creating a wildcard for investors.

The world remains a risky place, as it has always been. And the risks continue to seem somewhat greater than in the past perhaps because the worst case is so scary. However, we are conscious of the tendency for "today's" risks to always seem much more alarming than "yesterday's" risks.

What About Bonds?

Given current interest rate levels, it's fair to ask why we would own investment grade bonds. One reason is that economic risk has not gone away and bonds will likely be the best-performing asset class if the economy weakens again. Additionally, in an effort to align client's investment portfolios with their risk tolerance and time horizon constraints, bonds remain a critical component of some portfolios. However, we have concluded that the risk and return tradeoff inherent in longer dated maturities are unattractive. For this reason, we have emphasized short duration fixed-income portfolios and as bonds have matured in recent months we have boosted cash (money market funds) in lieu of further bond exposure. While we realize cash yields are very low; unlike bonds, cash (money market funds) won't decline in value if interest rates rise. It is our expectation that these funds will be reallocated to bonds as the risk/reward becomes more attractive.

Our firm will be successfully completing its fifth year of operations this August. Without our clients none of this would have been possible. Thanks again for the confidence that you have placed in Jolley Asset Management, LLC.
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