JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook

Volume 1, Issue 19 • Winter 2003

> **Julian Robertson--On who was most responsible for the market "bubble"**—"*Mr. Greenspan. He and all the other politicians and Fed chiefs. Their objective was: let's not let anything happen on my watch. They were not letting normal business corrections happen, setting us up for a doozy.*"

It was a strong fourth quarter for stocks even though the rally fizzled out in December. However, the fourth quarter strength was small consolation for an otherwise brutal year for equities. For the first time since 1941, the stock market has declined for three consecutive years, with 2002 representing the worst single year loss since 1974. During the past year, there was essentially nowhere to hide in the stock market. Every single sector in the Standard & Poor's 500 declined, and eight of the ten sectors experienced double digit losses. Only 3.8% of all equity mutual funds ended the year in positive territory (primarily precious metals funds). According to Lipper Analytical, mutual funds lost ground for the third consecutive year and in 2002 declined by an average of 22.4%.

Index	4th Qtr 2002	YTD 2002
DJIA	10.57%	-15.03%
S&P 500	8.43%	-22.09%
S&P Mid Cap	5.82%	-14.52%
Russell 1000/Growth	7.15%	-27.89%
Russell 1000/Value	9.22%	-15.52%
Value Line	7.90%	-28.57%
NASDAQ Comp.	13.95%	-31.55%

The "Bubble"

Before looking forward, it might be useful to review just why the past "bear market" phase has occurred. In our opinion, there are a number of factors that contributed to the bear market, but the biggest was the stock market/tech bubble. Terrorism and war fears didn't help, but these only contributed at the margin to the magnitude and length of the bear market. Corporate governance also contributed, but was not the main driver—it was more of an outgrowth of the environment of bubble-driven greed.

The "bubble" created three major problems. 1) Valuations got way out of line (which we warned our clients about on numerous occasions) and, while they have improved, they are still not cheap based on many statistical measures. 2) There was an over-investment in the general economy as corporate management became overconfident in their growth expectations. This has resulted in excess capacity that has not yet been fully absorbed, despite the fact that capital spending has declined dramatically. 3) Investors forgot about risk and were more heavily weighted to stocks than they had been in any previous bear market cycle. Now investors have become more risk-averse—and it may take years for investors to once again regain their appetite for risk. In the past, investors have remained cautious for several years after the end of a major bear market.

Valuations

As we have discussed in some of our most recent "*Investment Outlooks*", valuations can be looked at in many different ways, but in the charts below we would like to point out that stocks are cheap when compared to current interest rate levels (traditional dividend discount models—see Chart 2 below), but somewhat expensive using other valuation parameters. In its simplest form, dividend discount models essentially compare the yield on a risk-free treasury bond with the current earnings yield on the S&P 500. The general idea is that the competing returns should be more or less the same. For the last few months we have been pointing out that stocks had become very inexpensive relative to current interest rate levels, which has typically led to a rally in the equity market.

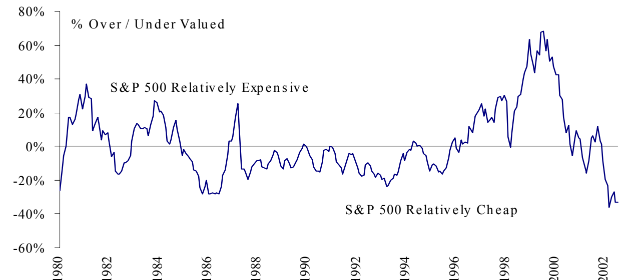


Chart 2—Source- Morgan Stanley

It is also prudent to look at other valuation metrics such as price/earnings ratios, price/book value, price/sales, price/cash flow and price/GDP. As can be seen in Chart 3 below, valuations on these metrics appear to be above average, but well below peak levels. It should be pointed out that valuation parameters are often tricky because the research methodology depend upon earnings estimates (forward) and interest rates (which can change rapidly).

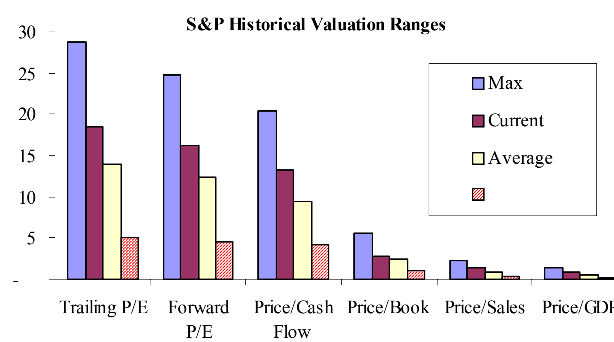


Chart 3—Source- Morgan Stanley

Earnings

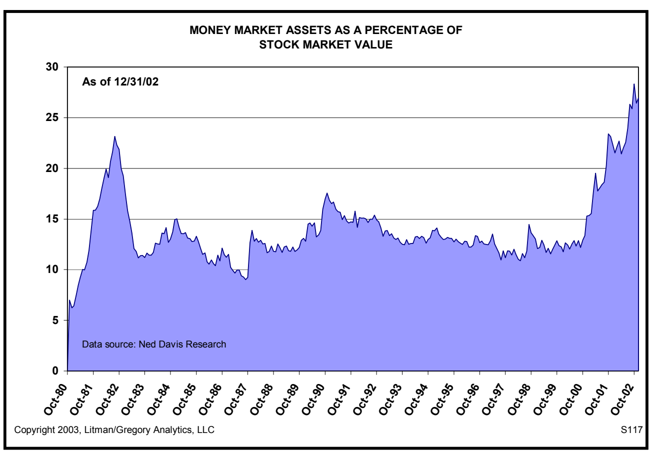
While valuation measures are mixed, earnings appear to be at a cyclical low and poised to rebound in the coming year.

Monetary and fiscal policy remains stimulative and should allow the economy to build on its slow recovery. Recent economic news has become increasingly positive and even manufacturing has begun to show signs of improvement. Inventories are lean so any pickup should result in higher corporate spending. Capital investment has been cut back so far that the capital stock is actually declining. A rebound in capital spending is inevitable and this would favorably impact corporate earnings going forward.

Over the long term, corporate earnings are the driver of stock price movements. In fact, the breaking point of the market in 2000 was the failure of earnings reports to match the wildly optimistic expectations. As we look into this year, earnings expectations appear much more reasonable. For that matter, equity market gains in the fourth quarter could be attributed to the 7% operating earning growth in the third quarter of 2002. First Call consensus earnings estimates call for fourth quarter (2002) earnings to climb 14% and for low-double-digit increases in the first half of 2003. This should provide support for equity prices over the coming year.

Liquidity

There remains lots of liquidity (see chart below) on the sidelines that at some point will begin to move out of cash and into equities. The bear market has caused investors to become more risk averse and look for safe havens in U S Treasury bonds and money market funds. Currently money market funds are yielding around 1% and the five year Treasury note just over 3%. Recently, the Bush Administration has proposed to eliminate the "double taxation" of dividends which would also encourage investors to begin to move money out of the safe haven asset classes and back into equities.



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Concerns

Our biggest concern coming into the new year is the consumer, which represents about two-thirds of the domestic economy. Lower interest rates have spurred massive mortgage refinancing, and zero percent auto financing, which has kept the consumer spending through the past economic downturn. However, with rates at such low levels, it is likely that we have seen the last major wave of refinancing for some time. In a typical economic cycle, the consumer retrenches by lowering spending and paying down their debt obligations. This has not happened in this cycle as the consumer debt load has actually increased. Evidence is starting to mount that the consumer is now beginning to retrench. December retail sales were well below expectations—some called it the worst retail environment in some thirty years. Consumer credit contracted by $2.2 billion in November, which would also support the notion that the consumer is beginning to cut back. Economists had actually expected consumer credit to increase by approximately $3.6 billion. It appears that any economic recovery will be somewhat tepid due to the lack of pent up consumer demand and high consumer debt levels.

The potential for war with Iraq is also a concern of investors. While it is possible Saddam Hussein will avoid war, the uncertainty surrounding the event is definitely a negative. Terrorism continues to be an unknown. We are well aware that there are security costs which will have a marginally negative impact on productivity. What remains to be seen is the impact of terrorism on economic behavior. This will be determined by whether there are terrorist attacks that alter consumer and business behavior in a lasting way. In times of uncertainty, equity investors demand a higher risk premium, suggesting a lid on stock prices. The increased government spending related to defense and homeland security could also cause concerns with regards to our federal deficit, resulting in a lower U S dollar and somewhat higher interest rate levels.

Summary

In summary, we have just experienced the longest losing streak in stocks since World War II. Valuations have improved dramatically from peak levels, but remain higher than what is typically experienced at market bottoms. Fears over terrorism, war, and corporate governance issues have taken their toll, but appear to be priced in stocks at this point in time. Cash levels in money market funds are extremely high and could serve as the fuel for a market advance as investors seek higher returns. The proposal by the Bush administration to eliminate the "double-taxation" of dividends could also serve as a catalyst for a market advance. While we do not expect 2003 to be a huge up year for equities, we do believe the risk/reward is becoming more compelling. It remains our belief that returns will be based more upon stock selection than some overall advance in the market indices. It will be our goal to make volatility our friend rather than foe by using such periods as an opportunity to buy or sell at a more attractive level. While we understand that these are difficult times for investors, we believe that our discipline, patience and value-oriented philosophy will serve our clients well over the coming year.

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