JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 23 • Winter 2004

> *"Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions. The purchasers view the current good earnings as equivalent to "earning power" and assume that prosperity is synonymous with safety."*
> *Benjamin Graham*

What a difference a year can make. The domestic equity market rebounded in 2003 as the S&P 500 Index rose by 28.6% and ended three straight down years. The big gains in the major market averages last year were a surprise, with most market strategists forecasting only moderate gains. The strong rebound came as great relief to investors, who had been pummeled by the market in 2000, 2001 and 2002. In those three years, the Dow Jones Industrial Average fell 38%, the S&P 500 by 49% and the NASDAQ plunged by some 78%. The market rebound was led by the tech heavy NASDAQ which surged by 50%, its third best year on record. Small and mid-cap stocks continued to outperform the larger cap indexes as can be seen in the chart below:

Index	4th Qtr 2003	YTD 2003
DJIA	13.39%	28.27%
S&P 500	12.13%	28.62%
S&P Mid Cap	13.18%	35.60%
Russell 1000/Growth	10.41%	29.75%
Russell 1000/Value	14.19%	30.03%
Russell 2000	14.52%	47.25%
NASDAQ Comp.	12.11%	50.01%

While 2003 was clearly a standout year for equities, both the S&P 500 and NASDAQ Composite have a long way to go to reach their previous highs made in 2000. The NASDAQ must climb by 152% to get to its high close of 5,048.62 (3/10/00), while the S&P 500 has to rise by 37.4% to reach its high close of 1527.46 (3/24/00). The Dow Jones Industrial Average is much closer to its previous all-time high, needing only a 12.1% advance to get to 11,722.98 (1/14/00). However, things have been pretty good for most value oriented investors. From the markets highs in March of 2000, value stocks have significantly outperformed growth stocks. From the beginning of the market downturn in March of 2000, until June 2002, the Russell 1000 Value Index actually increased by 7.4%, while the Russell 1000 Growth Index plunged by 51%. For many equity investors, the 1999 to 2003 period was an extremely painful financial experience. However, most value oriented investors escaped relatively unscathed, and many actually saw their portfolios increase somewhat over that difficult period.

Looking Ahead to 2004

Investors have a tendency to equate a strong economy and strong earnings growth with a good stock market. As a result, the consensus is that 2004 will bring a continuation of the stock market gains of 2003. While we believe the domestic equity markets will trend higher in 2004, it is our belief that most of the gains are likely to come in the first half of the year. During the first half, earnings comparisons should remain easy and the Fed is unlikely to make major policy changes in an election year. The prospects of higher interest rates and tougher earnings comparisons could likely frustrate investors in the second half of 2004.

Election Year

The year just ended represented the third year of an election cycle (see chart below), which is statistically the strongest of the four-year cycle. It is quite typical in the year before a presidential election to see legislative items introduced which will have a significant stimulative economic effect. The tax-cut implemented in 2003 and the war in Iraq carried significant ramifications for numerous industries and the equity markets. While the Federal Reserve Board is not directly linked with any particular political party, it is quite obvious they have co-operated with the Bush administration by holding rates down, even as inflationary pressures have begun to emerge. As we enter 2004, we leave behind the best-performing third year of an election cycle and move to a less favorable (at least statistically) fourth year. The chart below shows the results of the election year cycle (for the past 88 years).

Year	# of Years	Average % Gain
Election year	22	6.26%
1 year after	22	4.44%
2 years after	21	5.24%
3 years after	22	16.82%

Source: Smith Barney

In years where the incumbent wins, stocks tend to do better, even though full year performance during an election year cannot be known until the election itself is over. This correlation likely occurs due to perceptions about the economy's health and its influence on the stock market and the public's decision to re-elect an incumbent president. At the present, Bush's re-election prospects appear good, buoyed by a strengthening economy and progress in job growth prospects. While this could have positive implications for 2004, we would never recommend anyone rely solely on election year cycles in their investment decision making process.

Valuations

A year ago, we were on record stating that stocks were cheap based on traditional dividend discount models (comparing the earnings yield on stocks to current interest rate levels). We also pointed out that based on other valuation metrics, such as price/earnings ratios, price/book value, price/sales, price/cash flow and price/GDP that equity valuations appeared to be above average but well below peak levels. However, we discussed that earnings appeared to be at a cyclical bottom, and poised to rebound. Corporate earnings did rebound strongly as Gross Domestic Product grew at a remarkable 8.2% in the third quarter and is expected to show still-strong growth of some 4% in the fourth quarter. So while stocks increased dramatically off the bottom, so did corporate earnings. The end result is that stocks are now trading at what we would consider to be "fair value". With the S&P 500 year end price of 1050.71 and a projected 2004 S&P 500 Index earnings consensus of $67, the market is trading at roughly 15.7 times forward earnings. Based on estimated 2003 earnings, stocks are closer to 20 times earnings, a level that causes some concern, especially if the Federal Reserve decides to adopt a less accommodative policy.

When the major market indexes were going through a topping process in 1999 and 2000 we repeatedly discussed that we felt the "nifty-fifty" were very expensive especially compared to the rest of the market. In our *Investment Outlook— Winter 1999* we stated, "While the "nifty-fifty" is way over-priced in our opinion, values can be found in the broader market as evidenced by the median P/E ratio on the Value Line Index, which is approximately 16x 1999 estimates." The fact that the broad market was cheap, has not gone unnoticed on Wall Street and over these past few years the valuation gap has essentially been eliminated. The median price/earnings ratio for the Value Line Index has risen to 19 times earnings, approaching that of the larger capitalization indexes which still remain significantly below peak levels. In summary, the average stock has done pretty well over the past few years, while the NASDAQ and large capitalization indexes have suffered. In recent months, our focus has largely shifted away from the small and mid-cap area, to larger capitalization companies. This has not been by design, but rather a function of where we are finding value using our bottoms-up approach to stock selection. We have not changed our "multi-cap" approach; we simply are finding more ideas that meet our "buy" criteria in the large cap universe.

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Dividends

The tax cut of 2003 reduced the tax on qualifying dividends to 15%, the same rate currently applied to long-term capital gains. While many thought this would cause a surge in dividend paying stocks, that was simply not the case. Stocks within the S&P 1500 universe that do not pay a dividend, outperformed dividend payers by about 1700 basis points (or 17%) during 2003. Clearly investors are thinking about dividend paying stocks the wrong way. Many investors are looking at the dividend paying stocks as stodgy, boring companies with little or no growth prospects. However, investors might do better to look at dividend paying equities as bonds that pay out increasing amounts over time, along with the potential for capital gains over the long term. In light of the current tax laws, there could possibly be a permanent asset allocation shift by investors to stocks, rather than bonds for income. According to a recent article in *Business Week* magazine, $10,000 invested in the S&P 500 index in 1982 would have started yielding more each year than the Lehman Brothers Aggregate bond index after just a decade. Dividends tend to increase over time, while the interest rate on bonds essentially remains fixed. The article went on to point out that "Over 20 years, the stock portfolio would have paid out dividends totaling $18,166 beating the $17,836 earned by the bond portfolio. What's more the stock portfolio would have grown more than six-fold to $62,558, despite the 1987 crash and the 2000-2003 bear market."

While investors have not yet caught on, many companies have. In 2003, no less than 241 companies in the S&P 500 increased their dividends and a record 21 companies initiated their first-ever dividends. Further dividend increases are likely in 2004 as companies may decide to allocate capital previously used for share repurchases to higher dividend payouts. Probably most interesting is the fact that the dividend payers have been relative under-performers during the recent market recovery. We believe investors will start to pay attention and begin to emphasize companies that pay dividends. That will certainly remain a focus of ours going forward in the new year.

Fixed Income

For the year just ended, bonds as measured by the 30-year US Treasury Bond returned just .15% on a total return basis. With the strengthening economy, we believe the odds favor higher rates over the coming year, which will continue to provide a challenging environment for bond investors. For this reason, we are focusing on short-duration instruments and recently we have begun to purchase Treasury Inflation Protected Securities, better known as "TIPS" in our balanced portfolios. "TIPS" which were introduced by the US Treasury in 1997, are unique in that the principal amount of the bond is adjusted periodically for inflation. As you are probably aware, inflation is probably the biggest risk to the bond investor. With "TIPS", the investor is essentially assured a "real" rate of return after inflation, rather than see their investment lose purchasing power caused by higher inflation.

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