JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook **Volume 1, Issue 30• Fall 2005**

> *"Make no mistake about it, the froth in the U.S. housing market is about to lose its effervescence; the bubble is about to become less bubbly."*
>
> *William H. Gross (10/05)*
> *Managing Director, PIMCO*

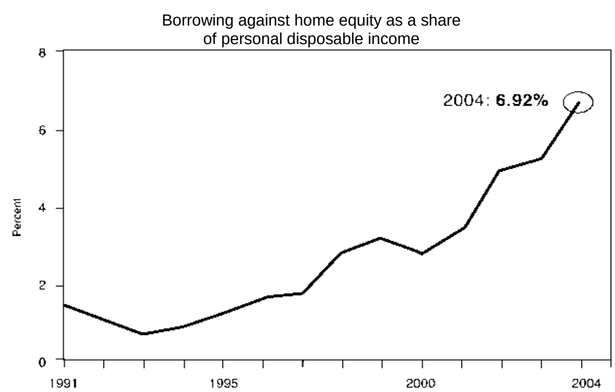
The S&P 500, Dow Jones Industrial Average and the NASDAQ Composite all posted their best advances of the year in the third quarter (see chart below). The move was impressive, considering the backdrop of devastating hurricanes, higher interest rates and soaring energy prices. Despite the positive quarter, returns for the nine months ended September 30, 2005 were mixed with the S&P 500 posting a total return of 2.79% while the DJIA (down .04%) and the NASDAQ Composite (-1.09%), remained slightly negative for the year. What gains there have been in 2005, have been largely focused in the energy sector, and without those, the returns would be even more lackluster for the year to date.

Index	3rd Qtr 2005	YTD 2005
DJIA	3.49%	- .04%
S&P 500	3.60%	2.79%
S&P Mid Cap	4.88%	8.92%
Russell 1000/Growth	4.01%	2.22%
Russell 1000/Value	3.88%	5.72%
Russell 2000	4.69%	3.38%
NASDAQ Comp.	4.61%	-1.09%

Third quarters have historically been the worst quarter for the equity markets, with an average loss of 0.6 percent for the S&P 500 going back to 1970. (September has been the worst individual month.) With the market surviving two of the costliest hurricanes to ever strike the United States, what awaits investors in the fourth quarter? Last year, stocks were saved by a fourth-quarter rally leaving the major indexes with moderate gains for the year. It is worth pointing out that the fourth quarter has historically been the best for stock market performance. Sam Stovall, the chief investment strategist at Standard & Poor's recently studied its 500-stock index going back to 1945 and found that the average fourth-quarter return was 4.3 %. Last year, the fourth quarter was even stronger, as evidenced by the surge in the S&P 500. Whether or not that rally will materialize again this year is a subject of continuing debate between bullish and bearish investors. Few predict either a sharp gain or a sharp decline. The main argument is between those who think the trading range will continue and those who see modest gains ahead.

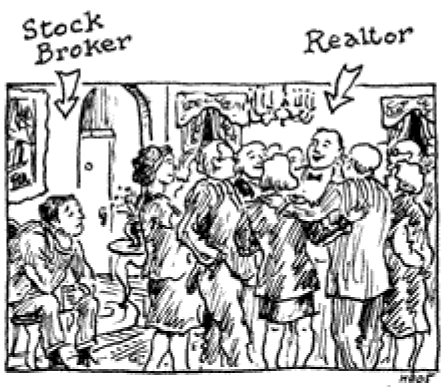
Hopes for modest gains are based on the passing of hurricanes Rita and Katrina and on expectations that companies will announce strong third-quarter profit reports in the next few weeks. Clearly the market will continue to face some headwinds such as high oil prices and rising interest rates. However, there is some thought that those head winds will dissipate somewhat as we move into 2006. As we approach the end of the year, investors will begin to anticipate an end to the Fed tightenings and analyze the prospects of a new Fed chairman. That could slow down the head wind and perhaps even turn it into a tail wind. The possibility of stable or lower energy prices could also ignite the equity markets.

Our biggest concern going forward relates to the consumer, who has become increasingly dependent upon borrowing against their home equity to fuel their spending. Fed Chairman Alan Greenspan recently made data available that show borrowing against home values added a stunning $600 billion to consumers' spending power last year, equivalent to 7% of personal disposable income, compared with 3% in 2000 and 1% in 1994. While Greenspan did not state how much of that went into spending, private economists have estimated approximately 50% or more. This would imply that home equity extraction could have added as much as 1% to GDP over the past few years. It is logical to assume that a slowdown in housing prices, coupled with higher interest rates are likely to result in a decline in home equity extraction and consumption.



Source: Wall Street Journal September 27, 2005
Alan Greenspan and James Kennedy, Federal Reserve

The Federal Reserve recently released a paper, "House prices and Monetary Policy: A Cross-Country Study". In that paper the Fed, examines the influences on housing price trends in various countries. The most important factors driving home prices were cited as demographics, financial deregulation, and interest rates. As Bill Gross, in a recent letter to PIMCO shareholders concluded, "Housing prices chase interest rates: when yields go down (short nominal rates, longer real rates) real housing prices go up. When yields go up, they go down." Gross also points out that real housing prices typically peak on average about four to six quarters (about 300 basis points) after the central banks begins raising rates. According to Gross, we are now approximately five quarters and 275 basis points into the tightening cycle, implying that we are now essentially at the point where housing has peaked. The real question is whether Greenspan can engineer a soft-landing, where housing simply slows down, without declining precipitously. Regardless, we believe home equity extraction will slow, and consumer expenditures will as well. How deep a slowdown will largely depend on many factors including energy price trends, China, and interest rate levels. In summary, we remain skeptical about the consumer and consumer cyclical stocks in particular.



The 2005 Cocktail Party

Investment Strategy

Over the past year, we have become convinced that the biggest bargains in the equity market are in the high quality, large capitalization names. Most of these shares peaked in early 2000, even though the businesses have grown and prospered over the past five years. What is even more interesting is the fact that we were not remotely interested in this sector of the market five years ago. The issue was never related to the quality of the business or its competitive position, but one of valuation. As an example, let's examine Microsoft, to see how the valuation has changed since early 2000. In 2000, Microsoft was viewed by the consensus as a can't miss investment opportunity with unlimited growth potential. Investors loved the shares and in early 2000, they traded north of $50 per share, while estimates for 2001 earnings were approximately $.90 per share. Today, Microsoft is trading at under $25 per share (just under 19 times estimated forward earnings) and sports a balance sheet with $38 billion in cash and no debt. When adjusting for the almost $4 per share in cash, Microsoft is essentially trading at a market multiple.

Microsoft Early 2000 versus 2005!

	2000	*2005*
Price	$51.22 *	$24.59**
Revenues	$25.3B a	$44B e
Earnings	$.90 a	$1.30 e
Dividends	Nil	$.32
Price/Earnings Ratio	56x	19x

**01/14/00 **10/07/05*
a) Actual 6/30/00 e) Estimated 06/30/06

In 1999 and 2000 we believed investors were over-paying for Microsoft's growth prospects, today we believe just the opposite. In fact, six years ago, in our *Fall 1999—Investment Outlook*, we shared this quote with you:

> *"There's such an overvaluation in tech stocks its absurd, and I'd put our company's stock in that category."*
> *9/23/99 Steve Ballmer, Microsoft* President

In summary, over the past 5 years, Microsoft has declined by over 50% despite substantially higher revenues, earnings and dividends. The company's substantial free cash flow generation and pristine balance sheet gives the company tremendous financial flexibility with regards to increased dividends, buybacks, and acquisitions. From a risk/reward perspective, the stock appears to be a much better bet today than it did in early 2000. In our opinion, the same statement holds true for a number of large capitalization, high quality companies.

Fixed Income

Last quarter we discussed the "conundrum" the Fed was up against with regards to falling bond yields, against the backdrop of nine consecutive tightening moves by the Fed. This past quarter actually saw bond yields rise by approximately 35 basis points on both the 10 and 30 year bonds. Furthermore, Greenspan went ahead and moved rates for the eleventh time in the last fifteen months despite the uncertainty surrounding Hurricane Katrina. In many cases our allocation to fixed income securities is not always about maximizing returns, but rather a way to manage risk in portfolios. We are continuing to emphasize short dated treasuries, high quality corporate issues and Treasury Inflation Protected Securities (TIPS) in our fixed income portfolios. We are simply not willing to take on the "interest rate risk" in the longer term maturities. The next few months should be interesting in the bond markets as the Fed appears to be serious in fighting the "asset price inflation" (i.e.: housing bubble) and appears to be jawboning that further moves could be coming. Perhaps, Mr. Greenspan is trying to get most of the 'dirty work" out of the way before handing over the reins to a new Fed Chairman in early 2006.

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