JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook

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Standard & Poor's Press Release—75% of Non-Technology Issues Recover from Post March 2000 Crash (March 8, 2005)

"The massive gains of the late '90's and the devastating losses resulting from the 2000 crash represent the risk-reward trade off that investors face with every investment. The enormous P/E's paid by investors for promised growth in the year 2000, have now been replaced with a more cautious investor who is saying "show me the money".

Howard Silverblatt-Standard & Poor's

A year ago the financial markets focused on terrorism threats and the presidential election. As you recall the markets struggled all year before taking off in October, just before the presidential election. In 2005, the markets began focusing on interest rates and inflationary pressures, weighing on first quarter returns. As can be seen from the chart below, the major indices headed lower in the first quarter, led by the 8.01% decline for the tech heavy NASDAQ. For the quarter, value was a standout, as evidenced by the positive return posted by the Russell 1000 Value Index (up by .09%). Small cap stocks (Russell 2000) were a weak spot, declining by 5.3% for the quarter after significant out-performance in previous periods.

Index	1st Qtr 2005
DJIA	-2.1%
S&P 500	-2.1%
S&P Mid Cap	-.4%
Russell 1000/Growth	-4.1%
Russell 1000/Value	.1%
Russell 2000	-5.3%
NASDAQ Comp.	-8.0%

Passive Investing?

March 24, 2005 was the fifth anniversary of the S&P 500 index hitting its peak at 1527.46—and the index remains down by approximately 23% from the days of the market bubble. Most of the losses in the S&P 500 Index came from its exposure to the technology industry, in fact in February of 2000, the technology sector accounted for 35% of the total market capitalization. According to Standard & Poor's, *"At that time, six of the top ten issues in the S&P 500 by market value were technology issues, representing $1.88 trillion. The combined market value of those six companies is now $0.77 trillion—a $1.1 trillion loss. Today only two of the six issues remain in the top ten and the representation of technology stocks within the S&P 500 now stands at 15%, down $2.3 trillion."* Further study of the S&P 500 index shows that 304 of the 404 non-technology issues are now at levels above that of March 24, 2000. While S&P will contend that its job is to reflect the market, it should be pointed out that the S&P 500 investment committee added twenty-four technology names to the S&P 500 in 2000 alone. Most of these additions were not to replace other technology companies, but rather in an attempt to not be outdone by the then soaring NASDAQ 100 index. We should point out that there were many winning investments over these last five years. Energy, financials, materials, consumer staples and health care (most of which were un-popular in the "bubble" environment of 2000) have all provided investors with nice total returns. Too bad, everyone was focusing on the "new economy". As we stated in our *Investment Outlook—Winter 2000 (from just over 5 years ago)*:

"In our opinion, the S&P 500 Index has lost its effectiveness as a proxy for the overall market due to the fact that is now totally dominated by just a few stocks."…. "We believe we are at a critical inflection point, where an investor must be willing to swim against the tide, even if it means foregoing short-term performance. It is our belief that great long term investment records are made by making tough decisions, which many times means going against the herd mentality. Buying what is popular has never worked on Wall Street. That is precisely why Jolley Asset Management, LLC was formed, to provide a vehicle whereby our focus and discipline could be preserved."

While indexing (passive investing) is held out by many experts to be a superior investment vehicle with low costs, it looks like over the past five years, the old axiom still applies, "you get what you pay for". The above referenced *Investment Outlook* can be read in its entirety at our website www.jolleyasset.com.

Financials are one of the sectors that led the market over the past five years and now represent the most heavily weighted group in the S&P 500 Index at 20%. In March of 2000, financials represented just 13% of the index. The rise in the financial sector is logical, given the significant interest rate decline over the same time period; however, we have become somewhat wary of the group over the past few quarters. Many value managers are over-weighted in financials, due to the fact that they trade at reasonable valuations, despite impressive earnings growth over the past decade. However, in just the past few months we have seen conditions deteriorate—problems with Fannie Mae, General Motors, and American International Group (to name a few) seem to be "the shot over the bow", warning us that risk is rising for this sector. Also concerning is the speculative activities in housing. A recent housing industry association report revealed that 23% of homes purchased last year were for "investment purposes". Is it an "investment" or "speculation" to purchase on maximum leverage an asset which produces a negative cash flow? Should speculative holders at some point be forced to sell, this would trigger a dramatic price decline and erosion of credit quality in the mortgage sector. Furthermore, Alan Greenspan has made it crystal clear in stating, “Rising interest rates have been advertised for so long and in so many places that anyone who has not appropriately hedged his position by now obviously is desirous of losing money.” We get the hint Alan and we don’t think rising rates will help the financials. That is the problem with passive investment strategies; even though a sector may appear problematic and over-valued, there is very little the index fund manager can do, except sit on their hands.

“All my lunch money’s in real estate.”

Outlook for Equities

Positives

- The economy is strong and corporate net profit margins have risen to an all time high of 7% for the S&P Industrials.
- The 12 month forward price/earnings ratio is currently around 15.5 times, which is reasonable in light of current interest rate levels.
- Corporations are flush with cash. In fact, non-financial S&P 500 companies have more than $750 billion in cash on their balance sheets. Furthermore, there seems to be a new sense of urgency to employ these cash balances. In addition a reduction in taxes on repatriated profits will further increase the cash held by many multi-national corporations. It is anticipated that this will result in increased mergers and acquisitions, initiations and increases in dividends, debt reduction, capital expenditures and share repurchase programs.

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Negatives

- The most critical negative consideration is current monetary policy. The Federal Reserve is continuing to push interest rates higher. Its target rate rose to 2.75% last month from just 1% last June. Many experts fear it could be at 4% before the year is over.
- Inflation as measured by the consumer-price index is up by 3% over the past twelve months. While 3% is not disastrous, it is much higher than the U. S. economy and the Federal Reserve have been accustomed to. The question is whether the Fed can engineer a soft-landing in its attempt to slow inflation and normalize the rate structure.
- Corporate profit margins are at peak levels on a historical basis and are likely to contract over the next several years.

Fixed Income

Inflation has been on the rise, and it isn’t just oil prices. Core inflation (which excludes the volatile food and energy sectors) has risen from a low of just over 1% in late 2003, to 2.4% as of the end of February. This number is still reasonable by historical standards, but the rate of change has been more severe than what we’ve seen in many years. Our belief is that this number will continue to increase, and the Fed will continue raising interest rates, albeit at a measured pace. This backdrop is not especially favorable for bonds, especially given the very low level of real yields. On the positive side, bond yields have been climbing recently, and higher yields contribute to better nominal returns going forward. This has been less noticeable at the long end of the yield curve, but intermediate-term bond yields have increased by roughly 50 basis points in just the last few months. In addition, the yields on taxable money market funds are now upwards of 2%, compared with approximately 1% just six months ago. Given the Fed’s current trend, those cash yields are likely to increase going forward. On the fixed income side, we continue to favor short duration treasury and corporate issues (municipals if tax-rates warrant), as well as treasury inflation protected securities (TIPS). It is our opinion that the long and intermediate term maturities are unattractive on a risk reward basis, given the current Fed posture.

Summary

The economy is strong and corporate America is flush with cash. Earnings have been exceptionally strong; however, we would caution that profit margins are at levels that have typically not been sustainable. The Federal Reserve has taken away the punch bowl, and continues to raise rates at a measured pace. As always, it is difficult to predict if the Fed will be able to engineer a “soft landing”. We do believe that opportunities exist in the equity markets and we continue to find companies that we believe offer an attractive risk versus reward tradeoff. As has been the case over the past few quarters, these opportunities have been concentrated in the large capitalization arena.

Frank G. Jolley, CFA