JAM JOLLEY ASSET MANAGEMENT, LLC

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> ***co·nun·drum***
> *Pronunciation: k&-'n&n-dr&m*
> *Function: noun*
> *Etymology: origin unknown*
> ***1 :*** *a riddle whose answer is or involves a pun*
> ***2 a :*** *a question or problem having only a conjectural answer*
> ***b :*** *an intricate and difficult problem*

The second quarter saw a variety of returns among the major equity indexes. The S&P 500 gained a modest 1.37% while the S&P Mid-Cap Index and Russell 2000 index posted advances of 4.26% and 4.32% respectively. The tech heavy NASDAQ bounced back, advancing 2.89% for the quarter. As can be seen in the chart below, the more cyclical Dow Jones Industrial Average actually declined by 1.85% for the past quarter. Returns for the six-months ended June 30, 2005 remained largely negative as the Dow Jones Industrial Average (-3.41%), S&P 500 (-.78%), Russell 2000 (-1.25%), and the NASDAQ Composite (-5.45%) all turned in negative total returns at the half-way point for 2005. Surprisingly, long term treasury bonds were up 8.4% in the second quarter and have outperformed equities (S&P 500) in four of the past six months. Past increases in short term rates by the Federal Reserve have always resulted in higher long term rates, but not this time.

Index	2nd Qtr 2005	YTD 2005
DJIA	**-1.85%**	**-3.41%**
S&P 500	**1.37%**	**-.78%**
S&P Mid Cap	**4.26%**	**3.85%**
Russell 1000/Growth	**2.46%**	**-1.72%**
Russell 1000/Value	**1.67%**	**1.76%**
Russell 2000	**4.32%**	**-1.25%**
NASDAQ Comp.	**2.89%**	**-5.45%**

Greenspan's Conundrum

The fact that long term interest rates have declined despite nine consecutive Federal Reserve tightening moves has baffled investors and economists over the past few months. Referring to the unexpected decline in long-term rates Alan Greenspan told the Senate Banking Committee in February, "the broadly unanticipated behavior of world bond markets remains a conundrum." It is quite unusual that the head of our Federal Reserve is mystified by the behavior of long term interest rates. Today the yield on the 10-year and 30-year Treasury bonds has fallen to 4.1% and 4.3%, respectively. This is lower than the average annual yield for these securities over the past twenty-five years. These low rates persist in the face of powerful factors which in historical terms should drive them higher, including monetary policy, strong domestic economic growth and the increasingly large current account deficit. However, the real conundrum lies much deeper than the shape of the yield curve. It centers on the speculative activity that low interest rates foster over time.

To understand our current situation, one must first go back to the late 1990's. Essentially, Greenspan refused to take away the punch bowl when a speculative frenzy bid up the "new economy" to dizzying heights. The end result was a dot.com and technology bust and mild recession. However, rather than allowing the speculative excesses which built up in the late 1990's to be essentially purged from the system, Greenspan pushed rates to forty-five year lows to help limit the damage. The end result was a strong bounce back in the economy, driven by the record low interest rates. While recently Greenspan has raised short-term rates nine times over the past year, they still remain extremely low by historical standards. Stephen Roach, the chief economist at Morgan Stanley summarizes the results of Greenspan's policies, "low savings rate, the housing bubble, high debt loads, and a runaway current account deficit".

Housing

Today we again face growing speculative activity. This time the speculation is not in the NASDAQ but in the real estate markets. In many areas of the country, property values bear little relationship to their underlying economics. Speculative demand is evidenced by the high proportion of new homes bought with no intention to occupy or rent but for resale (flipping) quickly at a higher price. Much of the speculative activity has been facilitated by the low rates and aggressive lending practices. On June 9, 2005, Greenspan testified before Congress, "The dramatic increase in interest-only loans and other relatively exotic forms of adjustable-rate mortgages are developments of particular concern. To be sure, these financing vehicles have their appropriate uses. But to the extent that some households may be employing these instruments to purchase a home that would otherwise be unaffordable, their use is beginning to add to the pressures in the marketplace." Interest only mortgages accounted for approximately 40% of the loans over

$360,000 in hot real estate markets like San Diego, Washington, Seattle, Reno and Atlanta according to Loan Performance, a mortgage data firm. It is interesting to note that the mortgage market was one-half the size of treasuries in 1990, now it is 20% larger. Mortgage holdings of banks now are almost three times the size of commercial and industrial loans. Home equity lines of credit alone now approximately match commercial and industrial loans.

The reason we are so focused on the explosion in real estate values (by the way there is no real estate bubble in Rocky Mount) is the implications for the domestic economy and the consumer. One of the significant impacts of the explosion in real estate values has been an increase in the net worth of the homeowner, which has financed a consumption boom through extracting equity from homes. It is estimated by Oppenheimer & Company that of the increase in net worth of the U. S. homeowner in the year 1999-2004, 69% came from rising real estate values and only 3.8% from appreciation of stocks. In the same period, the percent of net worth in real estate rose from 25.4% to 35.4%, while the proportion in equities fell from 36.6% to 29.4%. Futhermore, the boom in housing has had a huge impact on new job creation. According to the *Economist Magazine* (6/18/05), "Two-fifths of all American jobs created since 2001 have been in housing-related sectors such as construction, real-estate lending and brokering. If housing prices actually fall, the boost will turn into a substantial drag."

Clearly Greenspan may face his most daunting challenge yet. Can the Fed reign in asset inflation (housing) without an overkill? A collapse or serious decline in housing values could trigger a spiral of forced liquidation with serious negative implications on consumer confidence and consumption. The end of the wealth effect of the real estate boom and extraction of cash from equity would seem to translate into a slower growth in personal consumption. Perhaps Greenspan can engineer a soft-landing, where housing cools, without collapsing.

Strategy

As value investors, we are seeking bargains that we feel offer our clients the most compelling risk/reward scenario going forward. As we have pointed out over the past few quarters, we feel the small and mid cap areas of the market are relatively unattractive versus the high quality large capitalization companies which have essentially gone nowhere for the past six years. Actually small and mid-cap stocks have been in a "stealth" bull market as evidenced by the cumulative returns for the S&P Mid Cap and Russell 2000 indexes for the past six years of over 75% and 52%, respectively. Large capitalization stocks (S&P 500 Index) have actually declined by 5% for the six year period ended June 30, 2005. While we were big proponents of over-weighting small and mid cap stocks five or six years ago, we believe their out-performance cycle is coming to an end. While not dirt cheap on an absolute basis versus historical benchmarks, we believe that high quality, large capitalization companies represent the most attractive asset class on a relative basis. Our top ten equity holdings as of June 30, 2005 is comprised of Berkshire Hathaway, Wyeth, Dow Jones & Company, ConocoPhillips, Schlumberger, Applied Materials, Comcast, Microsoft, Nokia, and Coca-Cola. Our top ten equity holdings six years ago were an eclectic group of companies with a noticeable small and mid cap bias included: Ruddick Corporation, Trigon Healthcare, Bowl America, Hewlett-Packard, Philips Electronics, Unifi, Media General, Millipore, Schlumberger and PepsiAmericas. This is quite a contrast of where we are finding value now versus six years ago. Six years ago, technology and indexing were all the craze while the mid and small capitalization areas were largely ignored. In our opinion, the pendulum has now turned in favor of the large names and we believe our clients are positioned to benefit. Two of our most recent purchases are highlighted below:

<u>Anheuser-Busch (BUD—NYSE) $45.75 Yield 2.1%</u>
Anheuser-Busch is the world's largest brewer with significant brands such as Budweiser, Michelob, Busch and Natural Light. Anheuser dominates the American beer market with nearly a 50% market share. The company owns 50% of Group Modelo (Mexico) which makes America's most imported beer, Corona. The company is also making a push into China by partnering with Tsingtao and purchasing Harbin Brewing Group. The company's stock has recently been under pressure due to increased competitive pressures and is currently trading at just over 15 times 2006 earnings estimates.

<u>Applied Materials (AMAT—NASDAQ) $16.18 Yield .7%</u>
Applied Materials produces semiconductor fabrication equipment. The stock is down over 70% from its all time high of $57.50 reached in 2000. AMAT has an extremely strong balance sheet with cash over $6.4 billion or close to $4 per share. Due to the strong financial position, the company has recently initiated a cash dividend and share-repurchase program. The stock trades at just over 19 times 2006 earnings (less if adjusted for the large cash balance), which we believe is quite reasonable given its long term growth prospects and dominant position.

In summary, we believe our multi-cap value strategy will continue to serve our clients well over the coming year. Our focus on "downside risk" before assessing the "upside" potential remains a critical variable in our investment process. While earnings growth will likely slow over the coming year, corporate balance sheets are extremely strong and flush with cash. We will continue our search for compelling opportunities with an appropriate risk versus reward tradeoff.

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