JAM JOLLEY ASSET MANAGEMENT, LLC

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THE FOOL ME TWICE AWARD: *To investors who chased momentum stocks into the heavens last year as if they'd never heard of the crash of 2000. Adding to the 1999 feel of things, penny stocks soared, funky pro forma figures resurfaced and formerly disgraced Internet analysts dusted off their pompoms. All we need now is for a Wall Street strategist to say, "It's different this time."*

Gretchen Morgensen, NY Times (1/1/05)

Stocks finished the year with a strong fourth quarter, resulting in back to back yearly gains for the first time since 1999. The stock market, as measured by the S&P 500 index rose by 9.2% for the fourth quarter, bringing full year gains to a healthy 10.9%. Small capitalization stocks did even better as evidenced by the 18.3% return for the Russell 2000 Index. As shown in the chart below, the majority of the gains have come since Bush's re-election in November. Cash that had been sitting on the sidelines has been flowing into equities since the election, driving the S&P 500 to its highest level in over three years. Despite the gains over the past two years, the Dow Jones Industrial Average only managed a gain of 1.85% during Bush's first term, while the NASDAQ slid by more than 21% for the same period.

Index	4th Qtr 2004	12 mos. ended 12/31/04
DJIA	**7.55%**	**5.34%**
S&P 500	**9.22%**	**10.92%**
S&P Mid Cap	**7.91%**	**10.89%**
Russell 1000/Growth	**9.17%**	**6.30%**
Russell 1000/Value	**10.38%**	**16.49%**
Russell 2000	**14.09%**	**18.33%**
NASDAQ Comp.	**14.69%**	**8.59%**

In looking back at what turned out to be a relatively good year for equities, it is worth remembering back to early 2003, when even a decent year seemed to be wishful thinking. At that time we were coming off the most dismal year of the three-year bear market, and sentiment was extremely poor. Stocks continued to decline based upon investor concerns about Iraq, the economy, deflation and terrorism. Amidst this backdrop, the emotional reaction was to get more defensive. The rational reaction was to look at valuations and realize that the market was already pricing in much of the bad news. Investors who stayed the course and maintained equity exposure were well rewarded, with the S&P 500 rising by over 50% since it bottomed on March 11, 2003. Whether the rally can last far beyond Mr. Bush's second inauguration on January 20th is another question. First and second years of presidential terms are not known for especially strong equity markets. This is largely due to the inevitable policy changes that typically follow a presidential election.

One of the biggest surprises of 2004 was the bond market. Phil Roth, of Miller Tabak recently stated, "We almost had a miracle in the bond market this year." Despite five interest rate increases by the Federal Reserve, the bond market turned in a respectable performance. The ten year U S Treasury note generated a total return of 4.5% for the year. Foreign central banks (most notably in Asia) have been heavy buyers of U. S. Treasuries, in an effort to prop up the U. S. dollar. The Japanese and Chinese in particular want to avoid upward pressure on their currencies, which would make their exports more expensive. In light of the stronger economy and higher energy and commodity prices, most analysts expected the rate on the 10-year Treasury note to approach 5%; however, the strong foreign interest resulted in a year end yield of just 4.22%. It began 2004 at a yield of 4.25%. Keep in mind the 10-year Treasury bond is extremely important as it is the benchmark that is used to price fixed rate home mortgages. The continued low yields had a continued dramatic impact on consumer spending, the housing market and economic growth in 2004.

The Year Ahead

Given the strong move we have seen in stocks over the past couple of years, it's not surprising that we have modest expectations for the coming year. The current economy is generally healthy and global economic growth is near a thirty year high. Corporate earnings have been very strong and most corporations have significant cash on their balance sheets, which bodes well for increased dividends, stock buybacks, mergers and acquisitions, increased capital spending and job expansion. While earnings are expected to slow from the pace of 2004, they should increase around 7%, which is the historical average. Valuations are not as attractive as they were a couple of years back; however, they remain reasonable by most measures. On the other hand, many of the same risks that existed two years ago continue to impact our thinking. The threat of terrorism remains in the background as does the uncertainty in Iraq. We continue to have structural imbalances in the economy. In particular, we remain concerned over the ramifications of a dollar collapse on the world economy. A declining dollar could ultimately mean higher interest rates are required to attract capital to fund our current account deficit. With many consumers already facing high household debt levels, including a lot of variable rate debt, higher rates could depress consumer spending. This could also slow the housing market, which has been one of the strongest parts of the U. S. economy. While the investment community is enamored with small capitalization stocks, we continue to believe the odds favor high quality, large capitalization issues. As we have mentioned in our last few "Investment

Outlooks", small cap valuations are no longer cheap versus large cap stocks and they are trending towards expensive. Tobias Levkowich, a strategist at Smith Barney recently noted that the market's twenty five largest companies were trading at 16.8 times estimated 2004 earnings, versus 17.8 for the entire S&P 500. Historically this group has traded at higher price/earnings ratio than the overall S&P 500. In addition, the weaker U. S. dollar should favor earnings growth for many of the larger cap, multinational companies.

Investing Principles

Every investor needs principles to live by and the readings of Benjamin Graham provide us with a great starting point from which to begin. Graham, a successful value investor and lecturer at the Columbia School of Business is widely acknowledged to be the father of modern security analysis and value investing. His books are a must reading for professional investors. We would like to take this opportunity to share with you some of principles that we find most important and that we try to implement in our investment management process.

- Don't trust the market to properly value a stock. Everyone talks about how efficient the markets are, especially with the enormous amount of information readily available to the investing public. Graham stated, "The market price is frequently out of line with the true value, there is an inherent tendency for these disparities to correct themselves." He further states that undervaluation and overvaluation may persist for "an inconveniently long time". In a famous passage Graham stated, "The market is not a weighing machine, but a voting machine."

- Don't expect it to be easy to beat the market. Graham pointed out that most mutual funds and brokerage firm recommended lists had a very poor record when compared to the broad based indexes. Graham stated, "A creditable, if unspectacular result can be achieved by the lay investor with a minimum of effort and capability; but to improve this easily attainable standard requires much application and more than a trace of wisdom."

- Momentum investing or trend following work for short periods of time, not over the long term. Graham wrote, "In fifty years of investing we have not known a single person who has consistently or lastingly made money by following the market. We do not hesitate to declare that this approach is as fallacious as it is popular." Graham believed the biggest losses came from buying bad companies in good times. On the opposite end of the spectrum from momentum investing is value investing. In a "value" philosophy, price matters.

- It is impossible to successfully time the market. Graham spent an enormous amount of time trying to devise ways or formulas for getting into and out of the stock market. He eventually concluded that all the formulas failed. His conclusion was that stocks should be purchased when they are available for comfortably less than your best estimate of intrinsic value and sold when you can collect more than that sum. He found it impossible to gauge the broad direction of the market. Graham did insist on being diversified, owning at least ten and preferably thirty stocks.

- Base your investment decisions on companies past records, rather than on optimism about the future. Graham wanted to invest in companies that would benefit from an economic expansion, but also survive a downturn. Graham recommended companies with strong balance sheets, a record of earnings extending back seven years and a dividend. (Note—we may own companies that do not pay dividends, but in our opinion, most have the financial strength and resources to do so.) Dividends remain some of the most convincing evidence that reported earnings are real.

- Don't chase initial public offerings. The real problem with initial public offerings is that you are buying something when someone is trying to sell. The seller typically knows what the company is worth and he will not sell unless he is getting more. Graham pointed out "Somewhere in the middle of the bull market the first common stock flotations make their appearance. These are not priced unattractively, and some large profits are made by buyers of the early issues." As the bull market continues, "this brand of financing grows more frequent; the quality of the companies becomes steadily poorer; the price asked, and obtained, verge on the exorbitant…for every dollar you make in this way, you will be lucky if you end up only losing two".

- Buy out of favor issues and industries. Graham found most growth stocks as too risky for a defensive investor. He stated, "Of course, wonders can be accomplished with the right individual selections bought at the right levels and later sold after a huge rise and before a probable decline. But the average investor can no more expect to accomplish this than find money growing on trees." Graham pointed out that "typically projections have been too optimistic for winners and too dire for losers".

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