JOLLEY ASSET MANAGEMENT, LLC

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"It is not the responsibility of the Federal Reserve - nor would it be appropriate—to protect lenders and investors from the consequences of their financial decisions."

Ben Bernanke
August 2007

On the surface, the past quarter doesn't look that much different than what we have seen over the past few years. Actually, for the S&P 500 Index and the Dow Jones Industrial Index (up 2.02% and 4.21%, respectively) the past quarter turned out to be quite respectable. However, it should be pointed out that there was tremendous turbulence along the way, including a plunge in August which drove the major averages down 12% off the records set in July. Early in the quarter, credit markets tightened dramatically as investors began to fear a steep economic recession. This kicked off a near panic in the "quantitative" hedge fund arena who, ironically, all decided to take down their leverage in the same two week period. The Federal Reserve came to the rescue, providing massive liquidity to the financial system on August 11th and then followed up with a ½ point cut in the discount rate on August 17th. Bernanke's Fed then followed up with a ½ point cut in both the discount rate and the federal funds rate on September 18th. The Fed's move returned confidence to the financial markets and stocks roared back in September. As the chart below indicates there were certain areas of the market that didn't fare as well. Small capitalization stocks and mid-cap stocks rebounded off the lows, but still finished down for the quarter. In addition, value benchmarks, which have heavy weightings in financials, were also in the red for the quarter. The markets were led by large capitalization growth, which have come to life after seven consecutive years of underperformance.

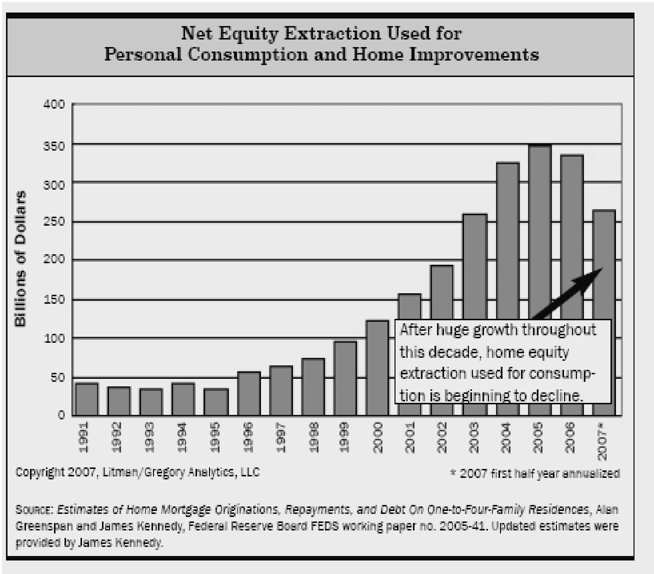
Index	3rd Quarter 2007	2007 YTD
DJIA	4.18%	13.37%
S&P 500	2.02%	9.15%
S&P Mid Cap	-.87%	11.01%
Russell 1000/Growth	4.21%	12.68%
Russell 1000/Value	-.24%	5.97%
Russell 2000	-3.09%	3.16%
NASDAQ Comp.	3.77%	11.85%

Helicopter Ben

In our *Investment Outlooks* written in January 2007 and April 2007, we concluded that any significant market correction or economic slowdown would likely be met by an accommodative Federal Reserve. During Alan Greenspan's tenure at the Fed, market participants felt comforted by the fact that in the face of any financial dislocations, the Fed would lower interest rates—"the Greenspan put". Recent actions by the Fed seem to imply to the markets that Bernanke will continue the Greenspan agenda of providing liquidity to head off any financial crisis. In 2002, Bernanke gave a speech discussing the impact of "deflation" on the economy. In that speech, he mentioned that the government in a fiat money system owns the physical means of creating money. He also referred to a statement made by Milton Friedman about using a "helicopter drop" of money into the economy to fight deflation. Bernanke's critics have since referred to him as "Helicopter Ben" or to his "helicopter printing press". Ironically, in August, Bernanke stated, "It is not the responsibility of the Federal Reserve - nor would it be appropriate - to protect lenders and investors from the consequences of their financial decisions." Why the abrupt change from him positioning himself as a conservative inflation fighter? According to records obtained by Kenneth Thomas, a lecturer at the Wharton School in Philadelphia, Bernanke's about face came after meetings with former Treasury Secretary Bob Rubin (now chairman of the executive committee at Citigroup), Raymond Dalio (founder of Bridgewater Associates—fourth largest US hedge fund) and Lewis Ranieri (founder of Hyperion Capital Management). What kind of answer did Bernanke think he was going to get? Like Warren Buffett once said, "Don't ask the barber if you need a haircut".

Moral Hazard?

Many have asked the question, has the Fed risked creating a moral hazard? If you protect someone too well against an unwanted outcome, that person may behave recklessly in the future. One could argue that the Fed created problems and ultimately "bubbles" by acting this way in 1998 (Long Term Capital Management collapse), 1999 (Y2K) and 2003 (Fed cut rates to 1% to head off recession risk). The risk lies in the fact that if investors believe the Fed will rescue them from their excesses; people will take greater risks and, ultimately suffer greater consequences. A recent article in the "*Economist*" magazine questioned "Does America need a recession?" The article points out that during the past quarter century the American economy has been in recession only 5% of the time, compared with 22% for the previous twenty five years. The author also states, "Many of America's current financial troubles can be blamed on the mildness of the 2001 recession after the dotcom bubble burst. GDP did not even fall for two consecutive quarters, the traditional definition of a recession." This action led to the housing boom and home equity extraction that propped up consumer spending. Economic recessions are painful,



but there are also some ultimate benefits. Joseph Schumpeter pointed out that recessions are a process of creative destruction in which inefficient firms are weeded out. The "*Economist*" article also points out that a recession purges the excesses of the previous boom, leaving the economy in a healthier state. They further state, "The Fed's massive easing after the dotcom bubble burst delayed the cleansing process and simply replaced one bubble with another, leaving American's imbalances (inadequate saving, excessive debt and a huge current account deficit) in place". The author of the article concludes that delaying the correction of past excesses will likely make the eventual correction more painful. A recent article written by Allan Sloan in "*Fortune Magazine*" entitled "Heads I Win, Tails I Get Bailed Out" criticized the Fed's recent move stating that it penalizes those of us who haven't over-reached. Sloan also questions the indirect bailout of companies like Countrywide Credit and states that the taxpayers shouldn't have to foot the bill. Interestingly, the Countrywide Credit CEO, Anthony Mozilo cashed out stock options valued at over $138 million over the past year. For Mozilo it looks like "Heads I win, Tails I win", was true to form.

Fixed Income

The fixed income markets were strong during the third quarter as investors were considering the consequences of an economic slowdown. For the third quarter, the Lehman Brothers Aggregate Bond index produced a total return of 2.8%. The benchmark 10-year Treasury note ended the quarter at 4.579% down from 5.034% at the end of the second quarter. As of October 5, 2007, the rate on the 10-year treasury bond had risen to 4.64% up from 4.47% the day before the Fed move on September 18th. Some investors fear the Federal Reserve's rate cuts could result in an over-heated economy and spur inflationary pressures. Furthermore, the Fed rate cuts have resulted in a weaker dollar, making our bonds less attractive to foreigners. Ironically, the back up in the 10-year bond rate provides little relief for the battered homebuilding and mortgage sectors.

Equities

According to "*Barron's Magazine*", it took the S&P 500 a mere 27 days to skid 12% from its mid-July peak to its Aug. 16th low, and 51 days to rebound to another new high (10/5/07). The headline grabbing news did little to change our investment strategy over the past quarter. We have learned over the years that market timing is a futile exercise. We believe valuations for the large capitalization sector continue to look attractive on a relative basis. The large capitalization multinationals are postured to benefit from the lower U S dollar and exposure to overseas economies which are growing faster than the domestic economy. One potential negative is slowing profit growth. According to a recent Wall Street Journal article, corporate profits are expected to post a third-quarter decline. This would mark the first such decline since the 2001 terrorist attacks. The companies in the Standard & Poor's 500-stock index are now expected to see a 0.4% drop in operating earnings, a figure that doesn't yet reflect the sizeable write-offs recently announced by Merrill Lynch & Co., Washington Mutual Inc. and Alcoa. A continuing concern is that profit margins have been rising steadily over the past three years and are currently at what could prove to be unsustainably high levels. Additionally, much of the earnings per share growth has come from a shrinking of the equity base funded by corporate borrowing. Michael Metz of Oppenheimer stated in a recent research piece that "The era of gorging on inexpensive and readily available credit is coming to an end." Private equity which has played a huge role in the equity markets over the past five years has slowed considerably over the past couple of months. While this slowdown will likely continue, we believe non-U.S. companies will take advantage of a weakened U.S. dollar and begin to target U. S. companies, creating a reasonable level of mergers and acquisitions over the next year.

Our research effort focuses on a bottom up stock picking approach, using fundamental analysis to search for companies to include in client portfolios. At this point in the cycle (over five years into the current bull market), we believe our discipline to focus on risk before reward will serve our clients well. Speculative momentum investment strategies have once again become all the rage of investors with little attention being paid to company valuations. Emerging markets have also become more dangerous in our opinion as share prices appear to be climbing at a hyperbolic rate. Bernanke's recent rate cuts have encouraged many investors to put on the "risk trade" again. We aren't biting.

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