JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook — Volume 1, Issue 34• Winter 2007

We still believe that the best opportunities in the market are the fallen growth stocks: stocks that have performed poorly over the past five years but whose businesses have continued to perform well. We believe these are still growth companies, but based on stock performance, they now look more like value stocks. *Bill Nygren—Oakmark Funds*

A year ago, stocks were stagnant and predictions were for 2006 returns to be modest (in the 6% to 7% range). After a difficult second quarter, many were beginning to question whether the markets would even live up to those modest expectations. However, falling commodity prices, massive liquidity and expectations that the Fed would be able to successfully engineer a "soft-landing" sparked a strong second half rally in equities. The rally produced new "all-time" highs for the Dow Jones Industrial Average, the Russell 2000 Index and the S&P Mid-Cap 400 index. Despite the strong second-half rally, the S&P 500 Index still remained approximately 7% below its all-time highs and the NASDAQ Composite remained approximately 53% below its all-time high reached in March of 2000. For the year just ended, the Dow Jones Industrial Average led the way with a 19% total return and the S&P 500 advanced by 15.8%. The S&P Mid-Cap 400 index and the NASDAQ Composite lagged the broader indexes. Ironically, the S&P Mid-Cap 400 index has been the best performing equity index over the past twenty years. Value investment styles once again outpaced growth across all market capitalization ranges.

Index	4th Quarter 2006	2006
DJIA	7.30%	19.00%
S&P 500	6.66%	15.80%
S&P Mid Cap	6.98%	10.32%
Russell 1000/Growth	5.93%	9.07%
Russell 1000/Value	8.00%	22.25%
Russell 2000	8.90%	18.37%
NASDAQ Comp.	6.95%	9.52%

Valuations

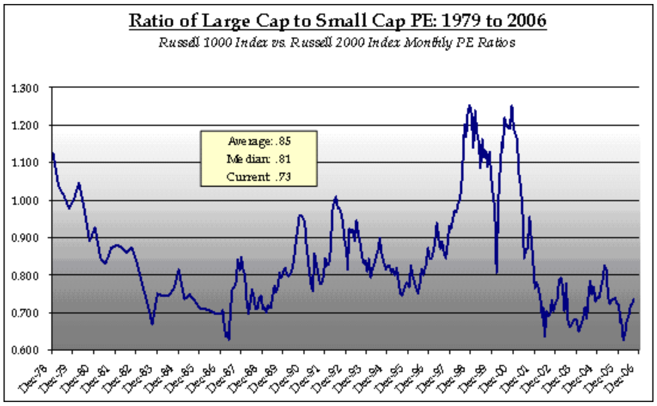
Despite the 15.8% return in the S&P 500 index last year, the valuation picture has actually changed very little. This is due to the fact that earnings have risen along with stock prices, leaving the relationship between prices and earnings at essentially the same place. According to Ed Keon of Prudential, the S&P 500 is currently at approximately fifteen times the consensus (bottom-up) estimates for 2007. Statistical data from Ned Davis Research show that the average price/earnings ratio for the last eighty years has been just under sixteen times earnings. The consensus earnings forecasts are calling for 8.9% earnings growth in 2007 versus 16% in 2006. The slowdown in profit growth would represent the first year of single digit earnings growth for the S&P 500 since 2002. Economists predicting the slower earnings growth are largely attributing the slowdown to weakness in manufacturing and housing. In addition, according to Thomson Financial, the energy sector profits are projected to grow only 1% in 2007 compared with 21% profit growth in 2006.

The Role of Private Equity

One of the major forces driving stocks over the past year has been the influence of the private equity industry, which according to Morgan Stanley, has some $300 billion of cash to invest. In 2006, private equity set new records with deal value approaching some $400 billion. In addition, it is expected that money flows into this sector will likely increase over the near term. It is anticipated that private equity targets will shift to larger companies and will include areas not typically associated with leveraged buyouts. For example, cash-rich technology companies with predictable cash flows are now becoming potential targets of private equity. In past years, the technology sector was not on the radar of private equity, due to the volatile earnings history. Strong earnings growth over the past four years coupled with a reluctance to significantly expand capital spending has led to a huge buildup of cash on corporate balance sheets. Many non-financial companies are under-leveraged by traditional measures. This is resulting in pressure for companies to capture incremental value for shareholders by re-leveraging rather than allow private equity groups to reap the benefits. As Michael Metz of Oppenheimer recently stated, "Speculators meanwhile are positioning themselves for the next takeover bonanza, assuming private equity provides a put for equities that will guarantee against loss, reminiscent of the infamous Greenspan put that guaranteed a torrent of cheap money would bail out speculators in case of emergency." Before getting too excited investors should realize that past merger waves have coincided with overvalued stock markets. According to Matthew Rhodes-Kropf, an associate professor of business at Columbia University, "Periods of high relative valuation are nearly always associated with high M & A activity and the stock market has fallen after each major merger wave."

Large Cap Focus

Our investment style could be best defined as multi-capitalization value. We believe that in order to generate the best risk-adjusted returns we need to have the flexibility to invest across the various market capitalization ranges. It is widely known in the investment community that, according to Ibbotson Data, small cap stocks have out-performed large cap stocks by an average of approximately 2% going back to 1926. For the last seven years, the out-performance has been even more pronounced. Small cap stocks (Russell 2000) and mid cap stocks (S&P Mid Cap 400) have been on major bull runs with annualized returns of 7.9% and 10.1%, respectively, since December 31, 1999, while large cap stocks (S&P 500) have returned a paltry 1.1%! However, we should point out that mean reversion typically takes over after significant periods of out-performance or under-performance. In early 2000, it was our belief that large capitalization issues had become too expensive to own—today, they are too cheap to ignore.

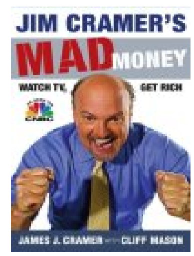


As we have discussed for the past year, we have been recently finding value in higher quality, large capitalization companies. The chart above shows that on a relative basis, large-caps are as cheap as they have been in roughly twenty years. In addition, many large multi-nationals should benefit from growth outside the U. S. and would also benefit from a falling U. S. dollar. Furthermore, the large cap universe (as a whole) has stronger balance sheets, which could be very important if the economy slows meaningfully in 2007. Richard Bernstein of Merrill Lynch believes that in 2007 returns in the equity market will be driven by price/earnings multiple expansion. Bernstein points out that in the last twenty years lower quality stocks have never outperformed higher quality ones during periods of price/earnings expansion.

Investor Psychology

After thirteen quarters of double-digit earnings growth investor expectations have gotten pretty high. According to a recent Merrill Lynch survey, 59% of fund managers think the economy will remain as strong as it is now or improve, compared to 32% last October. The same survey showed that half of the domestic fund managers think earnings will remain steady or improve in coming months, a year ago only 18% felt that way. This increased optimism is somewhat surprising; given the likelihood that earnings growth will begin to slow significantly in 2007. Perhaps investors have become too complacent due to the fact that today's market is easily the longest-duration bull market without at least a 10% correction. The S&P 500 corrected by 8% last spring, the smallest high-to-low pullback of any four year market cycle since 1934.

We have never been big fans of CNBC or much of the financial media for that matter. In fact, we believe the financial media played a significant role in the technology bubble of 1999-2000. Today, CNBC gives you Jim Cramer, who claims "he just wants to make you rich". Cramer, who has a law degree from Harvard University, is an ex-hedge fund manager turned financial journalist who has essentially taken over CNBC's airwaves. While Cramer is highly intelligent and has an uncanny ability to spew out information about practically any listed security—we believe he is unlikely to make you any *"Mad Money"*, in fact if you are not careful, he is likely to cost you some.



In Cramer's "lightning round", Jim tries to tell us whether to buy, hold or sell with split second decision making. While entertaining, lightning quick investment decisions are a recipe for financial disaster. When Warren Buffett lectures at business schools, he gives totally different advice, "I could improve your financial welfare by giving you a ticket with only twenty slots in it so that you had twenty punches—representing all the investments you got to make in a lifetime….and once you punched through the card you couldn't make any investments at all." He points out that under those rules, you would be forced to think very carefully about what you did. This is quite the opposite approach of Mr. Cramer, who wants you to follow his rapid fire decisions. Currently Jim Cramer's new book, *Jim Cramer's Mad Money: Watch TV, Get Rich*, is number twenty-one on Amazon.com's top seller list. One other thing, CNBC has a new show coming out called "*Fast Money*" which features Dylan Rattigan and four Wall Street traders, with cute names like the Admiral, The Risk Doctor, The Lone Wolf and the Negotiator. Not exactly the kind of things you see at market bottoms.

Summary

High quality, large cap stocks are attractively priced after seven years of stagnation. While earnings growth is likely to slow, stocks will continue to be supported by the massive liquidity provided by private equity and a re-leveraging by corporations. Investor sentiment has become too optimistic, increasing the odds of a meaningful correction. Any such correction would likely be accompanied by an accommodative Federal Reserve which would likely provide a lift to both stocks and bonds.

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