JAM JOLLEY ASSET MANAGEMENT, LLC

Investment Outlook Volume 1, Issue 41• Fall 2008

(Excerpt from Letter to Congress on the $700 Billion Bailout)

"Corrections are not all bad. The market correction process eliminates irrational competitors. There were a number of poorly managed institutions and poorly made financial decisions during the real estate boom. It is important that any rules post "rescue" punish the poorly run institutions and not punish the well run companies."

John Allison—BB&T CEO

For the quarter just ended the Dow Jones Industrial Average declined by 3.68% and the S&P 500 index fell by 8.49%. While this certainly was a bad quarter, it doesn't break into the top-ten worst quarters for the S&P 500 and is only the 25th worst quarter of all time for the Dow Jones Industrial Average. From the peak levels attained last October, the Dow Jones Industrials have declined 23% while the S&P 500 index has fallen by 26% (9/30/08). There was essentially nowhere to hide in the equity markets last quarter—our warning this summer to avoid the stocks and sectors that had bucked the trend was spot on, with many experiencing massive declines as the momentum players all exited at once. Small and mid-cap stocks outperformed the large caps for the first nine months of 2008, but it should be noted that they have been extremely weak in the first few trading days of the fourth quarter.

Index	3rd Quarter 2008	2008 YTD
DJIA	-3.68%	-16.46%
S&P 500	-8.49%	-19.43%
S&P Mid Cap	-10.87%	-14.34%
Russell 1000/Growth	-12.33%	-20.27%
Russell 1000/Value	-6.11%	-18.85%
Russell 2000	-1.11%	-10.38%
NASDAQ Comp.	-9.19%	-21.49%

Where's the Outrage?

Is anyone else outraged by the transformation of the United States into a country where profits are privatized and losses are socialized? Treasury Secretary Hank Paulson, who was the former Chief Executive officer of Goldman Sachs, has been given the power from Congress to buy $700 billion in distressed assets from financial institutions in what will be an unprecedented government intrusion into the markets. This is in addition to the following: 1) $29 billion to fund J. P. Morgan's takeover of Bear Stearns 2) Up to $200 billion each for the nationalization of Fannie Mae and Freddie Mac 3) Up to $50 billion to insure money market funds 4) Up to $85 billion of loans for American International Group 5) In addition, approximately $400 billion of Fed liquidity has been pumped into the markets. Paulson is "asking for a huge amount of power," said Nouriel Roubini, an economist at New York University. "He's saying, 'Trust me, I'm going to do it right if you give me absolute control.' This is not a monarchy." We got here by excesses over the past twenty years that was encouraged by lax Federal Reserve policy. Ex-Fed Chairman Alan Greenspan recently called the government's handling of the situation "bad". Never mind that ex-Fed chief, Alan Greenspan, set this train wreck in motion, with his specific policies regarding Long-Term Capital Management. This dramatically altered the financial landscape by creating what's known as the "Greenspan put". Making matters worse, he advocated the deregulation of the financial system and praised securitization every chance he got. While in charge, he never tried to put a stop to any dangerous policy but, rather, pursued it aggressively. Another major contributor to the current financial problems was an exemption granted by the SEC to five major investment banks (4/28/04) regarding an old rule on the amount of debt they could take on. Ironically, Hank Paulson who headed Goldman Sachs at the time was one of the executives pushing for the change.

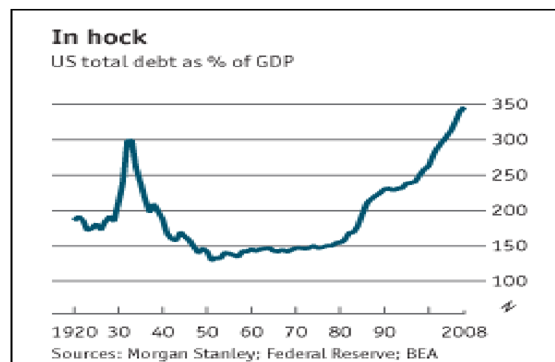
Hank Paulson—Most Powerful Man in the World?

Wall Street investment banks at one time were partnerships, where the top management had "skin in the game." The move to public ownership resulted in compensation via huge cash bonuses and stock option grants. This encouraged increased leverage (as much as 35:1 after the SEC exemption explained above) as a way to increase earnings—thus driving higher compensation for insiders. Wall Street executives raked in millions, while main street is now footing the bill. Wall Street's five biggest firms paid more than $3 billion in the last five years to their top executives, while they presided over the packaging and sale of loans that helped bring down the investment-banking system. Upon taking the job with the government as Treasury Secretary in June 2006, Hank Paulson sold approximately $500 million in Goldman Sachs stock. Guess what? One fringe benefit given to federal appointees who have to sell their holdings before taking office—a capital gains tax exemption—this saved Paulson tens of millions of dollars. John Thain, CEO of Merrill Lynch received a bonus in December of 2007 (he joined the

firm in November 2007) of $15 million and according to Bloomberg there is talk that he and trading-division head Thomas Montag may reap payouts totaling more than $47 million if they leave or are given lesser roles after Bank of America Corp. buys the firm. Thain has been at Merrill Lynch for less than one year. Where is the Board of Directors? What has John Thain accomplished in less than one year to deserve that compensation package? How did the shareholders come out? Not too good. At least Merrill Lynch is not being bailed out by the taxpayers. But Bear Stearns was, Fannie Mae was, Freddie Mac was and American International Group was. Shouldn't shareholders and bondholders be wiped out if the government is forced to re-capitalize a business? We have a Treasury Secretary that decides on a case-by-case basis who gets bailed out. Just ask Bill Gross who's PIMCO Total Return Fund reaped huge returns from the Fannie Mae/Freddie Mac bailouts, but lost big on AIG and Lehman Brothers.

Implications

The time to prepare for a bear market is before the difficult environment actually sets in. On July 9, 2007 Chuck Prince of Citigroup stated, "When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." While Chuck was playing musical chairs, we were playing defense. We had warned of the housing bubble (see *Investment Outlook—Summer 2005, Fall 2005*) and the implications of a "credit cycle" (*Investment Outlook-Spring 2007*) and we had invested our client portfolios bracing for more difficult times. It was our belief that the real estate contraction, coupled with huge leverage would result in significant problems for the financial sector—thus we underweighted the sector significantly. Playing it safe, we even moved client funds to money market funds that invested only in treasury obligations (in doing this our clients received less interest income). Little did we know that the rules of free market capitalism would change at the whim of the Federal Reserve board and the Department of the Treasury. Our clients who had money in the treasury backed money funds, received less interest while those taking more risk (and receiving higher returns) have been guaranteed that they will be made whole. We also sold certain positions in bank stocks because of the deteriorating loan portfolios—had we waited for the bailout and short-selling ban, we could have received a higher price for our clients (even though fundamentals have deteriorated since the sales were made). And now, even though many of these same institutions might be over-priced, you cannot capitalize by selling short (once again—they changed the rules). What happened to free-market capitalism? What is coming next? None of the bailouts have addressed our most pressing problem, the consumer balance sheet (see chart below). Perhaps our government can find a way to bail out those who have lived beyond their means and let those who have made prudent decisions pick up the bill. Don't get us wrong, our clients have fared better than most in this difficult economic backdrop, but we are outraged by this bailout mentality. There is no free lunch—just how much this will cost taxpayers is unknown, but it will be massive.



Investment Strategy

Enough about our "outrage" and what got us here, let's now focus on our strategy. Although we have never been market timers, in recent weeks, we have raised our cash allocation by eliminating a few equity positions without replacing them in equity portfolios. We view this as a temporary measure and fully expect to redeploy the funds into equities over the next several months. We would note that as of October 3, 2008 the S&P 500 index has declined by 28.1% from its peak reached in October 2007. According to Ned Davis Research the average bear market since 1960 has been approximately 31%. While this does not mean the pain is over, it is likely that a good portion of the problems are currently discounted into current stock prices Bob Farrell, the former market technician of Merrill Lynch stated that bear markets have three stages: Sharp down, reflexive rebound and a drawn-out fundamental downtrend. In our opinion, we have now entered the third and most painful phase. The big question is how long before the economy will begin to show signs of improvement. Clearly, corporate earnings will disappoint next year, and we expect the consumer will hunker down and reduce consumption in the next few months. However, investors must recognize that bear markets tend to lead recessions and are typically well over before the recession ends. We have been working overtime in recent weeks, searching for companies suitable for inclusion in our client portfolios. Company characteristics will likely include the following: they must be cash generators, they must be self financing (particularly important given credit markets) and they must have low debt/equity ratios (preferably net cash on the balance sheet). In some cases our search will likely take us to foreign markets. We realize that these are challenging times for investors. You can rest assured that no one takes their role as a fiduciary any more seriously than we do. We remain confident that our conservative, value oriented strategy will help you navigate through these difficult times.

Frank G. Jolley, CFA

JAM JOLLEY ASSET MANAGEMENT, LLC

210 Bryant Street, Suite A
P.O. Box 7967
Rocky Mount, NC 27804
(252) 451-1450 Toll Free (877) 4-JOLLEY
Web Site: www.jolleyasset.com
E-Mail: fjolley@jolleyasset.com